# CONTENTS

**Figures** xi  
**Tables** xiii  
**Contributors** xvii  
**Prefatory and introductory comments** xix  
**Acknowledgements** xxi  
**About the editor** xxiii  
**Abbreviations** xxv

## Part I  International Finance and Multilateral Financial Institutions

1. **CONTEMPORARY TRENDS IN THE INTERNATIONAL CAPITAL MARKETS** 3  
*Dilip K. Das*

2. **QUANTIFYING INTERNATIONAL CAPITAL MOBILITY IN THE 1980s** 27  
*Jeffrey A. Frankel*

3. **UNSTABLE CURRENT ACCOUNT BEHAVIOUR AND CAPITAL FLOWS IN DEVELOPING COUNTRIES** 54  
*Maxwell J. Fry*

4. **THE WORLD BANK IN THE 1990s** 72  
*Ibrahim F. I. Shihata*

5. **THE INTERNATIONAL MONETARY FUND'S ADJUSTMENT POLICIES AND ECONOMIC DEVELOPMENT** 86  
*Jacob A. Frenkel and Mohsin S. Khan*

6. **FINANCING IN EASTERN EUROPE AND THE FORMER SOVIET UNION: ISSUES AND INSTITUTIONAL SUPPORT** 101  
*Philippe Aghion and Robin Burgess*

## Part II  The European Monetary Union

7. **THE EUROPEAN MONETARY SYSTEM AND ITS FUTURE PROSPECTS** 129  
*Karl Otto Pöhl*

8. **EUROPEAN MONETARY REFORM: PROGRESS AND PROSPECTS** 148  
*Alberto Giovannini*
9 Monetary Policy in an Emerging European Economic and Monetary Union: Key Issues
Jacob A. Frenkel and Morris Goldstein

10 A European Central Banking System: Some Analytical and Operational Considerations
Niels Thygesen

11 The Economics of EMU
Directorate-General for Economic and Financial Affairs, Commission of the European Communities

12 One Currency for Europe: From Theory to Practice
André Fourçans

Part III World Equity Markets

13 Towards the Theory of World Stock Markets: An Overview
Jorge R. Calderón-Rossell

14 Market Efficiency and Equity Pricing: International Evidence and Implications for Global Investing
Gabriel Hawawini

15 An Introduction to Asian Capital Markets
S. Ghon Rhee, Rosita P. Chang and Roy Ageloff

Part IV Foreign Exchange Markets

16 International Financial Integration: Relations Between Interest Rates and Exchange Rates
Jeffrey A. Frankel

17 Foreign Exchange Rate Expectations: Micro Survey Data
Takatoshi Ito

18 Detecting Structural Changes in the Spot and the Forward Foreign Exchange Markets: From January 1974 to September 1986
Hiroya Akiba and Tomoki Waragai

19 The Purchasing Power Parity Criterion for Stabilizing Exchange Rates
Kenichi Ohno

20 Was There a Target Zone?
Takatoshi Ito

21 Why Floating Exchange Rates Fail: A Reconsideration of the Liquidity Trap
Ronald McKinnon
CONTENTS

22 THE DEBT DENOMINATION DECISION
   Robert Z. Aliber

   Part V International Debt Issues

23 COUNTRY RISK AND THE STRUCTURE OF INTERNATIONAL
   FINANCIAL INTERMEDIATION
   Donald R. Lessard

24 ORGANIZING DEBT RELIEF: THE NEED FOR A NEW INSTITUTION
   Peter B. Kenen

25 AN INTERNATIONAL DEBT FACILITY?
   W. Max Corden

26 BEYOND THE DEBT CRISIS: ALTERNATIVE FORMS OF
   FINANCING GROWTH
   Donald R. Lessard

27 THE USA IN DEBT
   Norman S. Fieleke

28 US BORROWING FROM JAPAN
   Jeffrey A. Frankel

   Part VI International Currency Markets

29 THE INTERNATIONAL USE OF CURRENCIES
   Stanley W. Black

30 THE DEUTSCHE MARK AS AN INTERNATIONAL CURRENCY
   George S. Tavlas

31 THE INTERNATIONALIZATION OF THE YEN
   Dilip K. Das

32 INTERNATIONALIZATION OF THE KOREAN CAPITAL MARKET
   Walter Mahler
FIGURES

1.1 Secondary market prices for developing country loans, 1986–April 1990 21
1.2 Asian and Latin American stock markets in dollar terms 22
2.1 US national saving (private saving plus government budget surplus), investment and current account; ten-year averages 31
2.2 US national saving, investment and current account 32
2.3 Dollar–pound real exchange rate 1869–1987, with period average 34
2.4 Financial liberalization in the UK: UK and Euro-dollar interest rates 41
2.5 Financial liberalization in Germany: German and Eurocurrency interest rates 41
2.6 Financial liberalization in Japan: Japanese and Euro-yen interest rates 42
3.1 Current account imbalances in Germany, Japan and USA 55
3.2 Current account imbalances in Korea, Sri Lanka and Taiwan 56
3.3 Domestic investment, national saving and the current account deficit 56
3.4 Life-cycle patterns of income, consumption and saving 58
3.5 Effect of rising foreign debt ratio on saving and investment ratios 65
3.6 Actual and simulated current account ratios in Korea, 1967–89 67
3.7 Actual and simulated current account ratios in Taiwan, 1963–87 67
3.8 Forecast current account ratio for Korea, 1989–2015 68
3.9 Forecast current account ratios for Sri Lanka and Taiwan, 1989–2015 68
8.1 The Italian lira, French franc and US dollar relative to the deutsche mark, 1959–89 149
8.2 The French franc in the European Monetary System, March 1979–December 1989 155
8.3 The Italian lira in the European Monetary System, March 1979–December 1989 155
8.4 Fluctuations in the lira–mark and franc–mark exchange rates, June 1973–December 1989 156
8.5 Inflation in France, Italy and Germany, January 1958–March 1989 157
8.6 Profitability of one-month investments: the franc relative to the mark, January 1981–May 1990 162
8.7 Profitability of one-month investments: the lira relative to the mark, January 1981–May 1990 162
8.8 Distribution of lira returns on shorting the mark: January 1981–June 1990 163
8.9 Profitability of one-year investments: the franc relative to the mark, January 1981–June 1989 163
8.10 Profitability of one-year investments: the lira relative to the mark, January 1981–June 1989 164
10.1 Domestic credit expansion and growth rates in nominal and real private final demand 202
11.1 Evolution of relative consumer prices in three monetary unions, 1950–88 217
11.2 Evolution of relative wage levels in three monetary unions, 1950–88 218
11.3 A graphical representation of alternative exchange rate regimes 224
16.1 Financial liberalization in Germany: German and Eurocurrency interest rates 335
16.2 Financial liberalization in Japan: Japanese and Euro-yen interest rates 336
16.3 Financial liberalization in the UK: UK and Euro-dollar interest rates 337
16.4 (a) The dollar and real interest rates; (b) US and foreign (G10) interest rates 348
18.1 Application of the AIC method for the detection of a structural change 377
18.2 Monthly observations of spreads between the three-month forward rate and the spot rate of the pound sterling 380
18.3 Monthly observations of spreads between the three-month forward rate and the spot rate of the French franc 380
18.4 Monthly observations of spreads between the three-month forward rate and the spot rate of the deutsche mark 381
18.5 Monthly observations of spreads between the three-month forward rate and the spot rate of the Swiss franc 383
18.6 Monthly observations of spreads between (a) the three-month forward rate and the spot rate and (b) the six-month forward rate and the spot rate of the Japanese yen 386
19.1 USA: internal price movements, 1960–88 (simulated with unchanged producer prices) 400
19.2 Japan: internal price movements, 1960–88 (simulated with unchanged producer prices) 401
19.3 Germany: internal price movements, 1960–88 (simulated with unchanged producer prices) 402
19.4 Nominal yen–dollar and mark–dollar rates 410
19.5 Wholesale prices 410
20.1 Yen–dollar rate in relation to five phases after the Plaza Agreement 417
20.2 Sliding zone experiment 422
21.1 Exchange rate overshooting with the interest rate immobile in the short run 430
21.2 Aggravated exchange rate overshooting with a perverse short-run adjustment in the interest rate 433
23.1 Impact of country risk on the risk premium: asset traded domestically and internationally 465
23.2 Impact of country risk on the risk premium: asset held exclusively by domestic investors 465
26.1 Modes of commercial finance 497
26.2 Debt relief and restructuring 504
27.1 Weighted average foreign exchange value of the US dollar, 1980–90 515
27.2 The current account and Federal budget deficits of the USA 525
27.3 The real exchange rate and the Federal budget deficit of the USA, 1973–89 526
28.1 Interest rates on the yen 538
TABLES

1.1 Selected economic indicators, 1982–9
1.2 Exchange rate volatility of major currencies with respect to the US dollar, 1984–9
1.3 Changes in cross-border bank claims and liabilities, 1983–1989.III
1.4 Change in interbank claims and liabilities, 1983–1990.III
1.5 Market for fixed rate bonds, 1985–9
1.6 Market for floating rate issues, 1985–9
1.7 Market for equity-related bonds, 1985–9
1.8 Gross international bond issues and placements by groups of borrowers, 1985–9
1.9 Early repayments of international bonds, 1985–9
1.11 International equity market – primary issues, 1984–8
2.1 The Feldstein–Horioka coefficient by decades: 1869–1987
2.2 The Feldstein–Horioka coefficient by years: 1929–87
2.3 The Feldstein–Horioka coefficient by years: 1955–87
2.4 Purchasing power parity between the USA and the UK
2.5 Real interest differentials (local minus Euro-dollar; three-month rates)
2.6 Country premia or covered interest differentials (local minus Euro-dollar; three-month rates)
2.7 Currency premia or real forward discounts
2.8 Return to forward exchange speculation
2.9 Real depreciation of currency
3.1 Current account imbalances in selected countries, 1972–89
3.2 Small-scale macroeconomic model of a representative developing economy
5.1 Cross-section estimates of growth and macroeconomic stability relationships
6A.1 European Bank for Reconstruction and Development financial structure: liabilities
6A.2 European Bank for Reconstruction and Development balance sheet
8.1 Intracommunity trade relative to trade with the rest of the world, original European Community countries, 1960, 1970 and 1989
8.2 Changes in unit labour costs and in the exchange rate, France and Italy relative to Germany, 1980–9
8.3 Change in real compensation per employee, Germany, France and Italy, 1979–89
8.4 Productivity growth, Germany, France and Italy, 1982–9
8.5 Adjusted relative wages and terms of trade, France and Italy relative to Germany, 1979–89
<table>
<thead>
<tr>
<th>TABLES</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>8.6 Balance of payments, Germany, France and Italy, 1983–9</td>
<td>159</td>
</tr>
<tr>
<td>8.7 Output growth and unemployment, Germany, France and Italy, 1983–9</td>
<td>160</td>
</tr>
<tr>
<td>8.8 Long-term government bond yields, Germany, France and Italy, 1979–90</td>
<td>167</td>
</tr>
<tr>
<td>8.9 Calibration of risk premia, for investors in selected currencies, 1981–9</td>
<td>169</td>
</tr>
<tr>
<td>8.10 Debt–GNP ratios, European Community countries, 1989</td>
<td>177</td>
</tr>
<tr>
<td>10.1 Ultimate and intermediate objectives of monetary and other macroeconomic policies and the instruments of monetary policy</td>
<td>199</td>
</tr>
<tr>
<td>11.1 Major features of 1992 and economic and monetary union</td>
<td>211</td>
</tr>
<tr>
<td>11.2 The economic meaning of the principle of subsidiarity: assigning tasks to the Community on efficiency grounds</td>
<td>212</td>
</tr>
<tr>
<td>11.3 Six differences between a single currency and irrevocably fixed exchange rates</td>
<td>215</td>
</tr>
<tr>
<td>11.4 Indicators of city and regional inflation divergence within Canada</td>
<td>216</td>
</tr>
<tr>
<td>11.5 Major features of the three stages of economic and monetary union</td>
<td>220</td>
</tr>
<tr>
<td>11.6 Realignments in the European Monetary System, 1979–89</td>
<td>222</td>
</tr>
<tr>
<td>11.7 Economic and monetary union and the theory of optimum currency areas</td>
<td>227</td>
</tr>
<tr>
<td>11.8 Major categories of effects of economic and monetary union</td>
<td>230</td>
</tr>
<tr>
<td>11.9 Measurement issues in the cost–benefits analysis</td>
<td>233</td>
</tr>
<tr>
<td>11.10 Assumptions and methods of quantitative evaluations of economic and monetary union</td>
<td>235</td>
</tr>
<tr>
<td>11.11 Macroeconomic models for simulations of economic and monetary union</td>
<td>237</td>
</tr>
<tr>
<td>11.12 A schematic presentation of costs and benefits of alternative exchange rate regimes</td>
<td>239</td>
</tr>
<tr>
<td>14.1 International evidence of daily seasonality in stock market returns</td>
<td>299</td>
</tr>
<tr>
<td>14.2 International evidence of monthly seasonality in stock market returns</td>
<td>301</td>
</tr>
<tr>
<td>14.3 International evidence of a size premium</td>
<td>303</td>
</tr>
<tr>
<td>14.4 International evidence of seasonality in the size premium</td>
<td>306</td>
</tr>
<tr>
<td>14.5 Risk and return characteristics of the largest and smallest size portfolios which have been partitioned into four subportfolios ranked by decreasing magnitude of their risk (β coefficient) in Japan and Belgium</td>
<td>308</td>
</tr>
<tr>
<td>14.6 Estimation of average risk premium and the average size premium based on the relationship [ RETURN_p, l = \gamma_0 + \gamma_1[BETA_p, l-1] + \gamma_2[SIZE_p, l-1, k] ]</td>
<td>309</td>
</tr>
<tr>
<td>14.7 A strategy for US investors to exploit the January size premium on the Tokyo Stock Exchange</td>
<td>311</td>
</tr>
<tr>
<td>14.8 Opportunities for international diversification across large and small capitalization portfolios</td>
<td>312</td>
</tr>
<tr>
<td>14.9 Risk and return characteristics of alternative international diversification strategies across large and small portfolios over the period 1977–86</td>
<td>313</td>
</tr>
<tr>
<td>15.1 Market size (as of December 1989)</td>
<td>320</td>
</tr>
<tr>
<td>15.2 Trading volume (as of December 1989)</td>
<td>321</td>
</tr>
<tr>
<td>15.3 Asian stock market indices (as of December 1989)</td>
<td>321</td>
</tr>
<tr>
<td>15.4 Summary statistics of Asian market portfolio returns (January 1980–December 1989)</td>
<td>322</td>
</tr>
<tr>
<td>15.5 Summary statistics of Asian market portfolio risk (January 1980–December 1989)</td>
<td>323</td>
</tr>
<tr>
<td>15.6 Correlation matrix: local currency return (January 1980–December 1989)</td>
<td>324</td>
</tr>
<tr>
<td>15.8 Price–earnings ratios and dividend yields (as of December 1989)</td>
<td>325</td>
</tr>
<tr>
<td>15.9 Brokerage fees and other costs (as of December 1989)</td>
<td>325</td>
</tr>
<tr>
<td>15.10 Trading hours and trading days (as of December 1989)</td>
<td>326</td>
</tr>
<tr>
<td>TABLES</td>
<td>Page</td>
</tr>
<tr>
<td>------------------------------------------------------------------------</td>
<td>------</td>
</tr>
<tr>
<td>15.11 Control of foreign exchange and foreign ownership (as of December 1989)</td>
<td>327</td>
</tr>
<tr>
<td>15.12 Withholding tax rates of foreign investors (as of December 1989)</td>
<td>328</td>
</tr>
<tr>
<td>16.1 Regressions of absolute covered interest differential against constant and trend, monthly data, September 1982–April 1988</td>
<td>338</td>
</tr>
<tr>
<td>16.2 Test for time-varying risk premium, ordinary least squares regression of expected depreciation on forward discount, June 1981–August 1988</td>
<td>341</td>
</tr>
<tr>
<td>16.3 Increased variances in the 1980s</td>
<td>342</td>
</tr>
<tr>
<td>16.4 Correlations among interest rates and stock prices, monthly data</td>
<td>343</td>
</tr>
<tr>
<td>16.5 Forecasting the inflation spread (twelve-month minus three-month) from interest rate term spreads, monthly observations, January 1955–December 1988</td>
<td>343</td>
</tr>
<tr>
<td>16.6 Techniques used by exchange rate forecasting services</td>
<td>350</td>
</tr>
<tr>
<td>16A.1 Exchange rate regressions</td>
<td>353</td>
</tr>
<tr>
<td>17.1 Time mean of $s_i(t, k) − s(t)$, May 1985–June 1987 (number of observations, 51)</td>
<td>362</td>
</tr>
<tr>
<td>17.2 Unconditional expected change, distribution among individual respondents of the time mean of forecasted changes in the exchange rate over the specified horizon</td>
<td>362</td>
</tr>
<tr>
<td>17.3 Group deviations from the total average, for each horizon</td>
<td>364</td>
</tr>
<tr>
<td>17.4 Wishful expectations, distribution of individual effects</td>
<td>364</td>
</tr>
<tr>
<td>17.5 Idiosyncratic effects: extrapolative form</td>
<td>365</td>
</tr>
<tr>
<td>17.6 Tests of rational expectations</td>
<td>368</td>
</tr>
<tr>
<td>17.7 Expectation formation, extrapolative expectation with one lag</td>
<td>370</td>
</tr>
<tr>
<td>17.8 Consistency tests</td>
<td>371</td>
</tr>
<tr>
<td>18.1 The UK: three-month spot–forward spreads</td>
<td>378</td>
</tr>
<tr>
<td>18.2 France: three-month spot–forward spreads</td>
<td>379</td>
</tr>
<tr>
<td>18.3 West Germany: three-month spot–forward spreads</td>
<td>381</td>
</tr>
<tr>
<td>18.4 Switzerland: three-month spot–forward spreads</td>
<td>382</td>
</tr>
<tr>
<td>18.5 Japan: (a) the three-month spot–forward spreads; (b) the six-month spot–forward spreads</td>
<td>384–5</td>
</tr>
<tr>
<td>18.6 Comparison of points in time of structural change, January 1974–September 1986</td>
<td>385</td>
</tr>
<tr>
<td>18.7 Comparison of points in time of structural change, January 1974–August 1985</td>
<td>387</td>
</tr>
<tr>
<td>18.8 Comparison of points in time of structural change, forward rate</td>
<td>387</td>
</tr>
<tr>
<td>19.1 Purchasing power parity estimates for 1990.I</td>
<td>413</td>
</tr>
<tr>
<td>23.1 Sources and dimensions of country risks</td>
<td>453</td>
</tr>
<tr>
<td>23.2 Incidence of country risk by type of claim</td>
<td>456</td>
</tr>
<tr>
<td>23.3 Sources of comparative advantage in international risk management</td>
<td>458</td>
</tr>
<tr>
<td>23.4 Comparative advantage in international risk management</td>
<td>459</td>
</tr>
<tr>
<td>24.1 Discounts on the debts of fifteen heavily indebted countries</td>
<td>472</td>
</tr>
<tr>
<td>27.1 International investment position of the USA at year-end, 1970–89</td>
<td>512</td>
</tr>
<tr>
<td>27.2 The US net international investment position: summary of changes during 1989</td>
<td>512</td>
</tr>
<tr>
<td>27.3 Net international investment position of the USA by area at year-end, 1981 and 1988</td>
<td>513</td>
</tr>
<tr>
<td>27.4 US balances on selected components of international current account transactions, 1970–89</td>
<td>514</td>
</tr>
<tr>
<td>27.5 Output per labour hour in manufacturing in selected industrial countries, 1970–88</td>
<td>516</td>
</tr>
<tr>
<td>27.6 Shares (as a percentage) in value of world manufactures exports</td>
<td>518</td>
</tr>
<tr>
<td>27.7 US and OECD GDP and US trade balance, 1981–9</td>
<td>518</td>
</tr>
<tr>
<td>27.8 Real GNP and real domestic demand in the USA and other OECD countries, 1981–9</td>
<td>519</td>
</tr>
</tbody>
</table>
TABLES

27.9 US merchandise trade, by major trading partners or areas, 1980 and 1987 520
27.10 US merchandise trade, by major end-use category, 1980 and 1987 521
27.11 Major categories of saving and investment as a percentage of GNP for the USA, 1970–90 523
27.12 Capital transactions in the US balance of payments, 1980–9 527
27.13 Percentage changes in US real output during recessions and the succeeding expansions, 1969–90 528
27.14 Selected debt burden indicators for the USA and other countries, 1989 529
27.15 Net US interest burden from external debt under differing assumptions 531
29.1 Currency distribution of world trade 555
29.2 Percentage of Japanese total trade invoiced in yen and other currencies, 1970–87 555
29.3 Shares of world exports 556
29.4 International bonds outstanding by currency of issue 556
29.5 International bank assets by nationality of bank 557
29.6 International bank assets by location of bank 557
29.7 The currency composition of banks' external assets 557
29.8 The currency composition of banks' foreign exchange market turnover 558
29.9 Share of national currencies in total identified official holdings of foreign exchange, end of year, 1979–89 559
29.10 Currency distribution of foreign exchange intervention by countries in the European Monetary System exchange rate arrangements 560
30.1 The roles of an international currency 567
30.2 Inflation and inflation variability 568
30.3 Currency invoicing of German foreign trade 571
30.4 Currency composition of turnover in major foreign exchange markets 572
30.5 Intervention in the European Monetary System in deutsch marks 573
30.6 Currency distribution of foreign exchange intervention 573
30.7 Foreign deutsche mark claims 574
30.8 Relative shares based on external capital market data 576
30.9 Currency shares of official exchange holdings, 1980–9 577
31.1 International positions by nationality of ownership of international assets, 1985–90 581
31.2 Yen invoicing of Japanese trade, 1975–89 583
31.3 Currency breakdown of exchange reserves, 1980–9 586
31.4 Current valuation of the special drawing rights basket 587
31.5 Yen- and foreign-currency-denominated funds raised by non-residents 587
31.6 Currency structure of international bond issues, 1986–90 589
31.7 Currency composition of foreign currency holdings for the reporting banks of the Bank for International Settlements 589
32.1 Korea: progress in capital market internationalization 593
32.2 Korea: investment by foreigners in Korean securities, 1981–8 593
32.3 Outline of international investment trusts 596
32.4 Outline of convertible bond issuing terms and conditions 598
32.5 Performance of portfolio foreign investment and convertible bonds 599
32.6 Premia or discounts of country mutual funds listed in stock exchanges in the USA 600
32.7 Korea: comparison of country fund premia 600
32.8 Korea Fund and Korea Europe Fund data, 1984–9 602