INTERNATIONAL MONEY AND FINANCE

C. PAUL HALLWOOD
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SECOND EDITION

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BLACKWELL
Oxford UK & Cambridge USA

First published 1986
Second edition 1994
Reprinted 1995 (twice)

Blackwell Publishers Ltd
108 Cowley Road
Oxford OX4 1JF, UK

Blackwell Publishers Inc.
238 Main Street
Cambridge, Massachusetts 02142
USA

British Library Cataloguing in Publication Data

A CIP catalogue record for this book is available from the British Library.

Library of Congress Cataloging-in-Publication Data

Hallwood, Paul.
International money and finance / C. Paul Hallwood and Ronald MacDonald. – 2nd ed.
p. cm.
Previous ed. published under title: International money. 1986
Includes bibliographical references and index.
ISBN 0–631–18149–0 (acid-free paper).— ISBN 0–631–18151–2 (pbk, acid-free paper)
1. International finance. I. MacDonald, Ronald. II. Hallwood, Paul. International money. III. Title.
HG3881.H255 1994
332.4'5 — dc20 93–25078
CIP

Typeset in 10 on 12pt Times by Colset Pte Ltd, Singapore
Printed and bound in Great Britain by Hartnolls Limited, Bodmin, Cornwall

This book is printed on acid-free paper

List of Figures

List of Tables

Preface to the Second Edition

The subject of international finance is developing faster than most other subjects in the field of economics. During the course of the last two decades, and especially in the last four or five years, the degree of international financial integration has increased enormously. All major country groups - OECD, developing country and, newest of all, the formerly centrally planned economies - are experiencing vastly increased cross-border flows of money and capital. Almost as rapidly growing is the mass of serious literature that is trying to describe and understand these developments. Important new developments have appeared in areas as diverse as the behaviour of exchange rates within a target zone such as the exchange rate mechanism of the European Monetary System (EMS); the theory of the optimal course of financial integration by countries previously divorced from the international circuit of capital; explanations for why real exchange rates wander away for long periods from purchasing power parity, so disturbing real economic activity; how misinformed speculation and speculative bubbles cause floating exchange rates to be unstable and largely unpredictable; and on how best to reform the international monetary system. And, as you will see, there is a lot more.

A glance at the bibliography gives some idea of the vast amount that has been written on international money and finance in the last several years. What you see there is only the tip of the metaphorical iceberg - we have tried to limit citations to the most important or, at least, to the best of those which crossed our desks. Apologies to all those authors of excellent papers that we have not got around to citing. To the first edition we have added new chapters on elementary theory (chapters 2, 3 and 4), international policy co-ordination (chapter 6), expectational failures and the questioning of the efficient market hypothesis (chapter 12), a statistical outline of international financial flows (chapters 1 and 15), the order of liberalization in developing countries (chapter 17), integration of the formerly centrally planned economies into the international financial economy (chapter 18) and international monetary reform (chapter 20). All of the other chapters have been updated and substantially revised and new material has been added.

The emphasis of our endeavour has been to describe the most significant modern theoretical institutional developments in the field and to examine the most important empirical research. We have also emphasized accessibility of the material to students with moderate levels of mathematics - intuitive, but nevertheless often quite rigorous, explanations appear alongside mathematical arguments. However, we have made as an important feature of the book an emphasis on the application of econometrics to the study of international finance. We realize that many students and teachers will not wish to get into as much econometric detail as we offer. For this reason the more advanced, indeed quite often 'state of the art', econometrics has been separated into sections marked with asterisks. Specialists in econometrics should find these sections a useful insight into how econometrics is being used in international finance today. Nonspecialist econometricians may simply omit them without loss of continuity. We also hope that graduate students embarking on their first substantial empirical investigations in the area of international finance will find the sections marked with an asterisk useful points of departure for their own research.

The book is aimed at second- and third-year undergraduate and graduate courses in international economics or international finance at British, other European, Canadian, Australian, New Zealand, and Indian and other Asian Universities. Undergraduates will probably want to omit the asterisked sections. In the USA graduate students will find the level acceptable.

The authors welcome comments on any of the material in the book. Also, they would like to thank the following people who have already offered helpful comments: Polly Reynolds Allen (University of Connecticut), Michael Artis (University of Manchester), Roy Batchellor (City University), Alpha Chiang (University of Connecticut), Paul Hare (Heriot Watt University), Panos Hatzipanayotou (University of Connecticut), Andrew Hughes Hallett (University of Strathclyde), Andreaus Karapatakis (Central Bank, Cyprus), Steven Miller (University of Connecticut), Susan Randolph (University of Connecticut), Stephen Sacks (University of Connecticut), Robert Shaw (University of Aberdeen), Scott Summer (Bentley College), Mark Taylor (IMF), Tom Torrance (Heriot Watt University), Hans Visser (Free University) and Immanuel Wexler (University of Connecticut). The authors are grateful to Ian Marsh for producing some of the diagrams in chapters 7 and 11.

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April, 1993

Contents

1 *Introduction*

In this book we build the tools needed to understand international finance and we apply them to a wide selection of issues – including among other things the operation, modelling and efficiency of foreign exchange markets, the history and future of the international monetary system, international macroeconomic policy co-ordination, international financial aspects of economic and financial reform in both the formerly centrally planned economies and the developing countries, monetary union in the European Community (EC), the international debt crisis, the functioning of international institutions such as the International Monetary Fund (IMF), the European Monetary System (EMS), international banking, and the rapid recent growth in international trading in bonds, equity and other financial instruments. We begin here with a brief description of the internationalization of finance – a factor which is driving many developments in economic theory and which is intimately related to many of the topics that we discuss in later chapters.

1.1 The internationalization of finance

In 1992, according to the Bank of England, the *daily* volume of foreign exchange transactions was $1,000,000,000,000 (i.e. $1 *trillion*), up from $650 billion in 1989. By contrast, in 1991 the *annual* value of world trade was $3.58 trillion, up from $3 trillion in 1989.[1] This makes international currency flows about 100 times larger than trade flows, up from 80 times only two years earlier. Indeed, there has been an 'explosion' of international financial flows over the last decade. London is the largest foreign exchange market with, in 1992, $300 billion of daily transactions in foreign exchange, followed in importance by New York and Tokyo.

As well as transactions in foreign exchange there are massive international financial transactions in domestic, foreign and Euro bonds, equities and derivative financial instruments. These transactions are partly responsible for the massive volume of trading in foreign currencies. There is also the very substantial international activity of banks. According to the Bank for International

Settlements, the *gross* stock of international bank credit at end-1991 amounted to $7.5 trillion, or 44 per cent of OECD gross domestic product (GDP), up from just 4 per cent in 1980.[2] Even in an era when direct foreign investment[3] is growing enormously, with an outstanding stock reaching $1.7 *trillion* end-1991, banking is one of the most internationalized of all industries. The foreign networks of the 100 largest banks taken together in 1985 amounted to over 4600 foreign offices: American banks had most (884), followed by French, Japanese, British and German.[4] The numbers are certainly larger today. Citicorp, the largest international bank, had 240 offices operating in 88 countries and its foreign operations were so considerable that they accounted for roughly one-half of, respectively, its assets, deposits and labour force. Barclays, the largest British international bank, had 187 foreign offices in 77 countries, and its foreign operations accounted for just short of one-third of its assets, deposits and employment. Japanese banks have recently entered the world stage on a big scale. Mergers by EC banks have accelerated in the last several years with, in 1990, 58 cross-border mergers between EC banks and a further 60 between EC banks and banks outside of the EC area.[5]

The spread of foreign branches, both in the banking and non-bank financial sectors, is important because it has provided a more efficient conduit through which much international finance moves. Moreover, dozens of cross-border acquisitions by commercial banks of investment banks and brokerage houses have occurred during the last decade with link-ups between American, Japanese and British finance houses being especially important as New York, Tokyo and London are the leading financial centres. Banks were especially active in acquiring securities firms. Three such examples are the tie-ups between Fuji Bank and the American merchant bank Walter E. Heller, Security Pacific and the British merchant bank Hoare Govett, and Citicorp and the British brokerage house Schrimgeour Kemp Gee.[6] Tie-ups such as these allow commercial banks to circumvent legislation such as the USA's Glass–Steagall Act (1933). This type of legislation is designed to separate commercial from investment (merchant) banking with the aim of increasing the soundness of commercial banks and the payments systems which they operate. Investment banking, e.g. the underwriting of share or bond issues, is inherently risky and so the reintegration of the two types of banking may have its dangers. In effect, by owning an investment bank a commercial bank is able to add equity instruments to its asset portfolio, thereby potentially increasing the riskiness of the portfolio.

Causes of internationalization

Several factors have driven the internationalization of finance during the last decade or so. The main ones are the cheapening of international financial transactions by low cost computer technology; financial deregulation, i.e. the lifting in virtually all industrial countries of quantitative controls on foreign exchange transactions and regulatory constraints on lending and restrictions on the composition of institutional investors' portfolios; the spread of markets in financial instruments to increasing numbers of countries; the development of a strong desire for international diversification on the part of portfolio-holders with the objective of reducing portfolio risk; the increased supply of financial