

Contents

1	Foreign Exchange Markets and Foreign Exchange Rates.....	1
1.1	Foreign Exchange Rate Quotations and Arbitrage.....	2
1.1.1	Foreign Exchange Quotations.....	2
1.1.2	Cross Rates and Arbitrage	3
1.2	Foreign Exchange Transactions	5
1.2.1	The Bid-Ask Spread.....	5
1.2.2	Transaction Costs and Arbitrage Opportunities.....	8
1.3	Spot and Forward Exchange Rates	11
1.4	Effective Exchange Rates	13
1.5	Other Currency Markets	15
2	Exchange Rate Regimes and International Monetary Systems.....	17
2.1	Exchange Rate Regimes	17
2.2	A Brief History of International Monetary Systems	21
2.3	The European Single Currency	25
3	International Parity Conditions	31
3.1	Purchasing Power Parity	31
3.1.1	Absolute Purchasing Power Parity.....	32
3.1.2	Real Exchange Rates	36
3.1.3	Relative Purchasing Power Parity.....	37
3.1.4	Empirical Tests and Evidence on PPP	39
3.2	Interest Rate Parities	45
3.2.1	Covered Interest Rate Parity	46
3.2.2	CIRP and Arbitrage in the Presence of Transaction Costs.....	51
3.2.3	Uncovered Interest Rate Parity	52
3.3	International Fisher Effect	55
3.4	Links Between the Parities: a Summary	57
4	Balance of Payments and International Investment Positions	59
4.1	Balance of Payments.....	60
4.1.1	Balance of Payments Accounts and Classification	61
4.1.2	Balance of Payments Entries and Recording	65

4.1.3 The Balance of Payment Identity.....	75
4.2 International Investment Position Statements and Analysis	76
 5 Open Economy Macroeconomics	85
5.1 The Balance of Payments, National Accounts and International Economic Linkages.....	85
5.1.1 National Accounts with an External Sector	85
5.1.2 International Economic Linkages	87
5.2 IS–LM in Open Economy Macroeconomics	89
5.2.1 IS–LM Analysis.....	89
5.2.2 IS–LM–BP Analysis.....	95
5.3 Aggregate Supply and Assumptions on Price Attributes.....	99
 6 The Mundell-Fleming Model	103
6.1 Effects and Effectiveness of Monetary Policy and Fiscal Policy - <i>Perfect Capital Mobility</i>	103
6.1.1 Monetary Expansion - Perfect Capital Mobility, Flexible Exchange Rates.....	104
6.1.2 Fiscal Expansion - Perfect Capital Mobility, Flexible Exchange Rates.....	107
6.1.3 Monetary Expansion - Perfect Capital Mobility, Fixed Exchange Rates.....	109
6.1.4 Fiscal Expansion - Perfect Capital Mobility, Fixed Exchange Rates.....	112
6.2 Effects and Effectiveness of Monetary Policy and Fiscal Policy - <i>Imperfect Capital Mobility</i>	114
6.2.1 Monetary Expansion - Imperfect Capital Mobility, Flexible Exchange Rates.....	115
6.2.2 Fiscal Expansion - Imperfect Capital Mobility, Flexible Exchange Rates.....	119
6.2.3 Monetary Expansion - Imperfect Capital Mobility, Fixed Exchange Rates.....	121
6.2.4 Fiscal Expansion - Imperfect Capital Mobility, Fixed Exchange Rates.....	124
6.3 Monetary Policy Versus Fiscal Policy	127
6.3.1 Effect on Income	127
6.3.2 Effects on the Exchange Rate and Official Reserves.....	129
6.3.3 Effect on the Balance of Payments Current Account	129
 7 The Flexible Price Monetary Model.....	131
7.1 Demand for Money in Two Countries and Foreign Exchange Rate Determination	131
7.2 Expectations, Fundamentals, and the Exchange Rate	137
7.3 Rational Bubbles and Tests for the Forward-Looking Monetary Model	140
7.4 Empirical Evidence on the Validity of the Monetary Model	144

8	The Dornbusch Model	149
8.1	The Building Blocks of the Model and the Evolution Paths of the Exchange Rate and the Price.....	149
8.2	Adjustments of the Exchange Rate and the Price and Overshooting of the Exchange Rate	154
8.3	A Tale of Reverse Shooting and the Sensitivity of Exchange Rate Behaviour.....	163
8.4	The Real Interest Rate Differential Model.....	167
8.5	Empirical Evidence on the Dornbusch Model and Some Related Developments	169
9	Global Derivatives Markets	173
9.1	Global Use of Derivatives – Current State, Trends and Changing Patterns	173
9.2	Organised Derivatives Exchanges, Contract Specifications and Trading	186
9.3	Use of Derivatives Shapes Investor Behaviour, Risk Management Concept and Risk Management Methods.....	200
10	Currency Futures	203
10.1	Futures Contracts and Trading.....	203
10.2	Futures Quotes	207
10.3	Pricing of Futures Products.....	210
11	Currency Options	219
11.1	Option Basics	219
11.2	Option Terminology and Quotes.....	229
11.3	Currency Options	233
11.4	Option Pricing – <i>the Binomial Tree Approach</i>	239
11.5	Option Pricing – <i>the Black-Scholes Model</i>	253
12	Currency Swaps	259
12.1	Basics of Swaps	259
12.2	Currency Swaps	263
12.3	Swapnotes	267
13	Transaction Exposure	273
13.1	Introduction to Transaction Exposure and Its Management	273
13.2	Forward Hedge and Futures Hedge.....	275
13.3	Money Market Hedge	281
13.4	Option Hedge	285
14	Economic Exposure and Accounting Exposure	289
14.1	Measuring Economic Exposure	290
14.2	Managing Economic Exposure	293

14.3 Measuring Accounting Exposure.....	295
14.4 Managing Accounting Exposure.....	300
15 Country Risk and Sovereign Risk Analysis.....	303
15.1 Factors of Influence on Country Risk	304
15.2 Country Risk Analysis and Ratings	306
15.3 Sovereign Risk Analysis and Ratings	317
16 Foreign Direct Investment and International Portfolio Investment	323
16.1 Recent Profiles of Foreign Direct Investment.....	323
16.2 FDI Types and Strategies.....	331
16.3 International Portfolio Investment.....	336
References	341
Index	347