

<b>Preface to the fifth edition</b>	xi
<b>Publisher's acknowledgements</b>	xiii
<b>1 Introduction</b>	<b>1</b>
Introduction	1
1.1 What is an exchange rate?	3
1.2 The market for foreign currency	14
1.3 The balance of payments	21
1.4 The DIY model	26
1.5 Exchange rates since World War II: a brief history	27
1.6 Overview of the book	37
Summary	38
Reading guide	39
Notes	39
<b>Part I THE INTERNATIONAL SETTING</b>	<b>45</b>
<b>2 Prices in the open economy: purchasing power parity</b>	<b>47</b>
Introduction	47
2.1 The law of one price in the domestic economy	48
2.2 The law of one price in the open economy	55
2.3 A digression on price indices	60
2.4 Purchasing power parity	63
2.5 Purchasing power parity – the facts at a glance	68
2.6 Purchasing power parity extensions	72
2.7 Empirical research	77
2.8 Conclusions	78
Summary	80
Reading guide	81
Notes	82
<b>3 Financial markets in the open economy</b>	<b>85</b>
Introduction	85
3.1 Uncovered interest rate parity	86
3.2 Covered interest rate parity	94
3.3 Borrowing and lending	96
3.4 Covered interest rate parity – the facts	100
3.5 Efficient markets – a first encounter	101

3.6	Purchasing power parity revisited	104
	Summary	108
	Reading guide	109
	Notes	109
<b>4</b>	<b>Open economy macroeconomics</b>	<b>112</b>
	Introduction	112
4.1	IS–LM model of aggregate demand	113
4.2	Aggregate supply	134
4.3	Conclusions	140
	Summary	141
	Reading guide	142
	Notes	142
	<b>Part II EXCHANGE RATE DETERMINATION</b>	<b>147</b>
<b>5</b>	<b>Flexible prices: the monetary model</b>	<b>149</b>
	Introduction	149
5.1	The simple monetary model of a floating exchange rate	150
5.2	The simple monetary model of a fixed exchange rate	158
5.3	Interest rates in the monetary model	167
5.4	The monetary model as an explanation of the facts	169
5.5	Conclusions	173
	Summary	173
	Reading guide	174
	Notes	174
<b>6</b>	<b>Fixed prices: the Mundell–Fleming model</b>	<b>176</b>
	Introduction	176
6.1	Setting	177
6.2	Equilibrium	180
6.3	Monetary expansion with a floating exchange rate	181
6.4	Fiscal expansion with a floating exchange rate	182
6.5	Monetary expansion with a fixed exchange rate	184
6.6	Fiscal expansion with a fixed exchange rate	186
6.7	The monetary model and the Mundell–Fleming model compared	187
6.8	Evidence	191
6.9	Conclusions	192
	Summary	192
	Reading guide	192
	Notes	193
<b>7</b>	<b>Sticky prices: the Dornbusch model</b>	<b>195</b>
	Introduction	195
7.1	Outline of the model	196
7.2	Monetary expansion	201
7.3	A formal explanation	205

7.4	Oil and the UK economy	209
7.5	Empirical tests: the Frankel model	215
7.6	Conclusions	216
	Summary	217
	Reading guide	217
	Notes	218
<b>8</b>	<b>Portfolio balance and the current account</b>	<b>220</b>
	Introduction	220
8.1	Specification of asset markets	221
8.2	Short-run equilibrium	225
8.3	Long-run and current account equilibrium	230
8.4	Evidence on portfolio balance models	232
8.5	Conclusions	236
	Summary	236
	Reading guide	237
	Notes	237
<b>9</b>	<b>Currency substitution</b>	<b>239</b>
	Introduction	239
9.1	The model	240
9.2	Evidence on currency substitution	247
9.3	Conclusions	248
	Summary	249
	Reading guide	249
	Notes	250
<b>10</b>	<b>General equilibrium models</b>	<b>252</b>
	Introduction	252
10.1	The Redux model	254
10.2	Extensions of Redux	272
10.3	Evidence	275
10.4	Conclusions	276
	Summary	277
	Reading guide	278
	Notes	278
	Appendix 10.1: Derivation of price index (Equation 10.2)	280
	Appendix 10.2: Derivation of household demand (Equations 10.6 and 10.6')	282
	Appendix 10.3: Log linearization of model solution (Equations L1-L4)	282
	Appendix 10.4: Sticky prices	284
<b>11</b>	<b>Optimum currency areas and monetary union</b>	<b>285</b>
	Introduction	285
11.1	Benefits of monetary union	288
11.2	Costs of monetary union	293
11.3	Other considerations	296
11.4	Currency boards	306
11.5	Conclusions	308

Summary	309
Reading guide	310
Notes	310
<b>Part III A WORLD OF UNCERTAINTY</b>	<b>315</b>
<b>12 Market efficiency and rational expectations</b>	<b>317</b>
Introduction	317
12.1 Mathematical expected value	318
12.2 Rational expectations	320
12.3 Market efficiency	324
12.4 Unbiasedness	326
12.5 The random walk model	327
12.6 Testing for efficiency: some basic problems	329
12.7 Spot and forward rates: background facts	330
12.8 Results	332
12.9 Conclusions	335
Summary	336
Reading guide	337
Notes	337
<b>13 The ‘news’ model and exchange rate volatility</b>	<b>340</b>
Introduction	340
13.1 The ‘news’ model: a simple example	341
13.2 The monetary model revisited	343
13.3 Testing the ‘news’	349
13.4 Results	353
13.5 Volatility tests, bubbles and the peso problem	355
13.6 Conclusions	360
Summary	360
Reading guide	361
Notes	362
<b>14 Microstructure models</b>	<b>364</b>
Introduction	364
14.1 Order flow analysis	365
14.2 Order flow	369
14.3 Microstructural analysis	376
14.4 Conclusions	386
Summary	388
Reading guide	388
Notes	389
<b>15 The risk premium</b>	<b>391</b>
Introduction	391
15.1 Assumptions	392
15.2 A simple model of the risk premium: mean–variance analysis	393

15.3	A general model of the risk premium	396
15.4	The evidence on the risk premium	402
15.5	Conclusions	403
	Summary	403
	Reading guide	404
	Notes	404
	Appendix 15.1: Derivation of Equation 15.12	405
<b>16</b>	<b>A certain uncertainty: non-linearity, cycles and chaos</b>	<b>407</b>
	Introduction	407
16.1	Deterministic versus stochastic models	408
16.2	A simple non-linear model	409
16.3	Time path of the exchange rate	411
16.4	Chaos	424
16.5	Evidence	429
16.6	Conclusions	433
	Summary	435
	Reading guide	435
	Notes	436
	<b>Part IV FIXED EXCHANGE RATES</b>	<b>439</b>
<b>17</b>	<b>Target zones</b>	<b>441</b>
	Introduction	441
17.1	What is a target zone?	443
17.2	Effect of target zones	444
17.3	Smooth pasting	448
17.4	An option interpretation	450
17.5	A honeymoon for policymakers?	458
17.6	Beauty and the beast: the target zone model meets the facts	461
17.7	Intramarginal interventions: leaning against the wind	463
17.8	Credibility and realignment prospects	465
17.9	Conclusions	467
	Summary	467
	Reading guide	468
	Notes	469
	Appendix 17.1: Formal derivation of the model	470
<b>18</b>	<b>Crises and credibility</b>	<b>472</b>
	Introduction	472
18.1	First-generation model	473
18.2	Second-generation crisis models	481
18.3	Third-generation models	490
18.4	Conclusions	496
	Summary	496
	Reading guide	497
	Notes	498

## **Part V CONCLUSIONS**

501

### **19 Conclusions**

503

Introduction

503

19.1 Summary of the book

503

19.2 Where do we go from here?

505

**Appendix: list of symbols**

508

**Bibliography**

510

**Index**

518