Contents

1	For	eign 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			
	1.2	Foreign Exchange Transactions	5		
		1.2.1 The Bid-Ask Spread	4		
		1.2.2 Transaction Costs and Arbitrage Opportunities			
	1.3	Spot and Forward Exchange Rates	10		
	1.4	Effective Exchange Rates			
		Other Currency Markets			
2	Exc	hange Rate Regimes and International Monetary Systems	. 13		
_	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 Conditions31				
3	2.1	Purchasing Power Parity	21		
	3.1	3.1.1 Absolute Purchasing Power Parity	31		
		3.1.2 Real Exchange Rates	34 24		
		3.1.3 Relative Purchasing Power Parity	٠٠٠٠٠٥٠		
		3.1.4 Factors Contributing to the Departure from PPP	3		
		3.1.5 Empirical Tests and Evidence on PPP	در۲		
	3.2	Interest Rate Parities	72		
	3.4	3.2.1 Covered Interest Rate Parity			
		3.2.2 CIRP and Arbitrage in the Presence of Transaction Costs	54		
		3.2.3 Uncovered Interest Rate Parity	5. 51		
	3.3				
		Links Between the Parities: a Summary			
4	Bala	ance of Payments and International Investment Positions	6.		
	4.1	Balance of Payments	64		
		4.1.1 Balance of Payments Accounts and Classification	6:		

		4.1.2 Balance of Payments Entries and Recording
		4.1.3 The Balance of Payment Identity80
	4.2	International Investment Position Statements and Analysis81
5	Ope	en Economy Macroeconomics91
	5.1	The Balance of Payments, National Accounts
		and International Economic Linkages91
		5.1.1 National Accounts with an External Sector91
		5.1.2 International Economic Linkages
	5.2	IS-LM in Open Economy Macroeconomics95
		5.2.1 IS-LM Analysis
		5.2.2 IS-LM-BP Analysis
	5.3	Aggregate Supply and Assumptions on Price Attributes
6	Bala	ance of Payments Issues and Exchange Rate Movements109
	6.1	The Elasticity Approach109
	6.2	The Absorption Approach118
		The Monetary Approach121
	6.4	DIPI Analysis and DIDI Analysis
7	The	Mundell-Fleming Model139
•	7 1	Effects and Effectiveness of Monetary Policy and Fiscal Policy
	7.1	- Perfect Capital Mobility
		7.1.1 Monetary Expansion - Perfect Capital Mobility,
		Flexible Exchange Rates
		7.1.2 Fiscal Expansion - Perfect Capital Mobility,
		Flexible Exchange Rates
		7.1.3 Monetary Expansion - Perfect Capital Mobility,
		Fixed Exchange Rates
		7.1.4 Fiscal Expansion - Perfect Capital Mobility,
		Fixed Exchange Rates147
	7.2	Effects and Effectiveness of Monetary Policy and Fiscal Policy
		- Imperfect Capital Mobility
		7.2.1 Monetary Expansion - Imperfect Capital Mobility,
		Flexible Exchange Rates151
		7.2.2 Fiscal Expansion - Imperfect Capital Mobility,
		Flexible Exchange Rates155
		7.2.3 Monetary Expansion - Imperfect Capital Mobility,
		Fixed Exchange Rates
		7.2.4 Fiscal Expansion - Imperfect Capital Mobility,
		Fixed Exchange Rates
	7.3	Monetary Policy Versus Fiscal Policy163
	1.5	7.3.1 Effect on Income
		7.3.2 Effects on the Exchange Rate and Official Reserves
		7.3.3 Effect on the Balance of Payments Current Account
		7.3.3 Effect on the balance of rayments Current Account

8	The Flexible Price Monetary Model	167
	8.1 Demand for Money in Two Countries and Foreign Exchange Rate	
	Determination	
	8.2 Expectations, Fundamentals, and the Exchange Rate	174
	8.3 Rational Bubbles and Tests for	
	the Forward-Looking Monetary Model	
	8.4 Empirical Evidence on the Validity of the Monetary Model	180
9	The Dornbusch Model	185
	9.1 The Building Blocks of the Model and the Evolution Paths of the	
	Exchange Rate and the Price	185
	9.2 Adjustments of the Exchange Rate and the Price and Overshooting	
	of the Exchange Rate	190
	9.3 A Tale of Reverse Shooting and the Sensitivity of Exchange Rate	
	Behaviour	
	9.4 The Real Interest Rate Differential Model	206
	9.5 Empirical Evidence on the Dornbusch Model and Some Related	
	Developments	208
10	The Portfolio Balance Approach to Exchange Rate Determination	215
	10.1 Three Assets and Market Equilibria	215
	10.2 Effects of Monetary Policy under the Portfolio Balance Approach	219
	10.3 Effects of Changing Economic Environments and Risk Perceptions	
	10.4 Theoretical and Empirical Research and Developments in the	
	Portfolio Balance Framework	236
11	Global Derivatives Markets	241
1 1	11.1 Global Use of Derivatives –	24 1
		241
	Current State, Trends and Changing Patterns	241
	11.2 Organised Derivatives Exchanges,	256
	Contract Specifications and Trading	230
	11.3 Use of Derivatives Shapes Investor Behaviour, Risk Management	260
	Concept and Risk Management Methods	265
12	Currency Futures	271
	12.1 Futures Contracts and Trading	271
	12.2 Futures Quotes	275
	12.3 Pricing of Futures Products	278
13	Currency Options	287
	13.1 Option Basics	287
	13.2 Option Terminology and Quotes	297
	13.3 Currency Options	
	13.4 Option Pricing – the Binomial Tree Approach	307
	13.5 Option Pricing the Black Scholes Model	

xiv Contents

14	Currency Swaps	33
	14.1 Basics of Swaps	
	14.2 Currency Swaps	
	14.3 Swapnotes	
15	Transaction Exposure	345
	15.1 Introduction to Transaction Exposure and Its Management	345
	15.2 Forward Hedge and Futures Hedge	
	15.3 Money Market Hedge	
	15.4 Option Hedge	
1.	Committee Commit	261
10	Economic Exposure and Accounting Exposure	301
	16.1 Measuring Economic Exposure	
	16.2 Managing Economic Exposure	363
	16.3 Measuring Accounting Exposure	36
	16.4 Managing Accounting Exposure	372
17	Country Risk and Sovereign Risk Analysis	375
	17.1 Factors of Influence on Country Risk	376
	17.2 Country Risk Analysis and Ratings	
	17.3 Sovereign Risk Analysis and Ratings	
18	Foreign Direct Investment and International Portfolio Investment	395
	18.1 Recent Profiles of Foreign Direct Investment	395
	18.2 FDI Types and Strategies	404
	18.3 International Portfolio Investment	409
Re	ferences	415
Ind	lex	427
	·-··	