

## **RECENT ADVANCES IN INTERNATIONAL FINANCE: INTRODUCTION**

YIN-WONG CHEUNG\* *University of California, Santa Cruz*

*Abstract.* Arguably, international finance is one of the most exciting areas in economics. The development of international finance is influenced and shaped, at least in part, by the continuing process of globalization and integration. In the last 25 years the profession has witnessed the proliferation of both theoretical models and empirical analyses in international finance. The analysis of both new and existing issues has benefited from increasingly elaborate modelling techniques and sophisticated empirical tools.

Given its rapid and diverse developments, it is infeasible, if not impossible, to prepare an issue for the *Pacific Economic Review* that will highlight, in a balanced manner, the current landscape in international finance. Thus, this special issue on 'Recent Advances in International Finance' is bound to be selective, and to cover some but not all the important and interesting developments. We have ended up with five articles for this issue – three from the USA and two from the UK. They can be summarized as follows.

There is an ongoing, and at times contentious, debate on the implications of the economic integration that has been steadily occurring throughout recent decades. A fundamental issue is how to assess the degree of integration between economies or markets in different geographical locations. Robert Flood and Andrew Rose, in 'A New Approach to Asset Integration: Methodology and Mystery', propose an alternative method for measuring financial market integration. Their method is based on the argument that when markets are integrated assets should not have market-specific discount rates. Thus, markets should be integrated when assets in these markets are all priced by the same (and, possibly, time-varying) discount rate. Under a general intertemporal pricing framework and the assumptions of rational expectations and constant asset-specific systematic risk, one can estimate the unobservable discount rate for each asset (or portfolio). Then the estimated discount rates can be used to test whether the unobservable discount rates are the same across assets (portfolios). Applying the proposed test for integration, Flood and Rose find that the S&P 500 market is integrated; other markets, however, including NASDAQ, the Toronto Stock Exchange and the US bond markets, are not. Further, there is no evidence of integration between these markets.

The purchasing power parity (PPP) hypothesis is perhaps the international parity condition that has been examined the most in recent years. One of the

\*Address for correspondence: Yin-Wong Cheung, Department of Economics, University of California, Santa Cruz, CA 95964; Email: cheung@ucsc.edu.

issues considered in recent writings is the so-called PPP puzzle – the enormous short-term volatility and the torpidly slow convergence rate of real exchange rates. Ronald MacDonald and Luca Ricci examine the implication of the distribution sector on real exchange rate dynamics in ‘The Real Exchange Rate and the Balassa Samuelson Effect: The Role of the Distribution Sector’, and find that their results help explain this puzzle. A theoretical model that includes tradables, non-tradables and the distribution sector is used to illustrate the potential impact of the distribution sector for real exchange rate dynamics. The empirical results derived from the US dollar real exchange rates against eight European countries and Japan are supportive of the notion that real exchange rates are influenced by developments in national distribution sectors. Specifically, real exchange rates are found to respond to changes in the relative productivity and the relative product market competition of the distribution sector, even after controlling for the Balassa–Samuelson effect and other macroeconomic variables. The authors also assert that the convergence speed of real exchange rates is close to a year, once the relevant fundamentals are included in their regression.

In ‘Does “Aggregation Bias” Explain the PPP Puzzle?’ Shiu-Sheng Chen and Charles Engel investigate whether the observed PPP puzzle can be attributed to the bias induced by the aggregation procedure used to construct price indexes. The analytical calculation suggests that the aggregation bias is insignificant unless, for instance, the component series are very different from each other. The authors also report simulation results that are supportive of the analytical results. Measurement errors are ruled out as a possible explanation of their findings. Chen and Engel also point out that both univariate and panel data tend to yield downward biased persistence estimates in small samples. This small-sample downward bias goes against the upward bias induced by the aggregation procedure. Simulation results suggest that the downward bias tends to dominate the aggregation upward bias in small samples. Actual data from European countries, controlling for data errors, do not reveal an aggregation bias substantial enough to explain the PPP puzzle, either.

The effectiveness of foreign exchange intervention carries significant policy implications. However, empirical analyses of foreign exchange intervention are not as common as, say, of those of purchasing power parity. This may be because, in general, intervention data are not readily available to researchers. The portfolio balance effect and the signalling channel are two mechanisms through which invention can influence exchange rates. Mark Taylor, in ‘Official Foreign Exchange Intervention as a Coordinating Signal in the Dollar–Yen Market’, explores whether intervention affects exchange rates via a ‘coordination channel’. Specifically, a Markov switching model with transition probabilities determined by fundamentals is used to investigate the intervention effect. The transition probability is found to depend on the deviation from the equilibrium real exchange rate, the duration of any state intervention and the interaction between intervention and deviation from the equilibrium real exchange rate. The empirical evidence is considered to be supportive of the ‘coordination channel’ effect because the probability of intervention achieving real exchange rate stability increases with the magnitude of deviation from the equilibrium rate.

Since the 1997 financial crisis, there has been a concerted effort to improve policy coordination and enhance economic integration in the East Asian region. In the fifth article of the special issue, 'The Suitability of a Greater China Currency Union', Yin-Wong Cheung and Jude Yuen consider the possibility of a currency union between the Greater China economies, i.e. China, Hong Kong and Taiwan. The authors show that these three economies have extensive trade and investment linkages. The authors' empirical results show that the economies share common long-run and short-run cyclical output variations. They also provide some preliminary output cost estimates resulting from the economies' relinquishing policy autonomy to form a currency union. The estimated output losses seem to be moderate and are likely to be less than the efficient gains to be derived from a currency union arrangement. Despite the encouraging results, however, it is noted that there are both economic and non-economic obstacles to establishing such a union.

I would like to thank the authors for their contributions and the referees for their timely and valuable comments and suggestions. Undeniably, the selection of articles was heavily swayed by my own personal preferences, as well as the referees' input. Last, but not least, I am grateful to Ken Chan, the editor of this Journal, for his continued support and encouragement during the entire process.