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Session 5: International Capital Market

The international capital market

1. In which sense is the global capital market (i.e., international capital mobility) a benefactor and in which sense might it be a menace?
2. The primary reason for the expanding volume of foreign exchange transactions and international financial intermediation is the growth in the volume of international trade. Explain.
3. Why do you think capital controls tend to go hand-in-hand with fixed exchange rates?
4. What does the behaviour of interest rate differentials reveal about the effectiveness of capital controls?
5. The foreign exchange market is an important part of the international capital market. In contrast to the international goods market where several reasons prevent goods prices from equalising across countries, arbitrage in the foreign exchange market seems to be sufficient to bring exchange rates into parity within hours, even minutes, of a disturbance to international markets. Why does arbitrage seem to work in foreign exchange markets and not in goods markets?

International portfolio diversification

6. Among the following portfolios, the one that is the least diversified is that consisting of stocks of
   - ❑ Book publishing and TV set producing companies
   - ❑ A football team and retail stores
   - ❑ Real estate and General Motors
   - ❑ Airline companies and travel agencies

7. Supposed you want to form a 3 asset portfolio. Which of the following assets you would rule out if the expected rate of return, its variance and its covariance with the rest of the portfolio were: {4%, 0.1, 0}, {3.8%, 0.1,-0.1} {4.5%, 0.1, 0}, {3.8%, 0.1, 0} for assets *A*, *B*, *C*, and *D* respectively.
   - ❑ *A*
   - ❑ *B*
   - ❑ *C*
   - ❑ *D*
8. It is always possible to construct a portfolio in such a way as to achieve perfect hedging (zero variability). Evaluate.

Financial crises and contagion

9. How does Summers (2000) define the term ‘international financial crisis’. Evaluate its implications.
10. Give an informal definition of what is meant by contagion. Give some explanations of contagion, following Summers’ text. How are international financial crises and contagion linked?
11. Summers (2000) describes some means of crisis prevention at the national and international level. Is he supporting the idea of controls on short-term capital inflows? Why (not)?
12. Once a international financial crisis is present, what are Summers’ (2000) recommendations to the governments of the hurt country?

Regulating International Banking

13. Why is the international capital market regulated?
14. After the developing country debt crisis began in 1982, U.S. bank regulators imposed tighter supervisory restrictions on the lending policies of American banks and their subsidiaries. Over the 1980s, the share of U.S. banks in London banking actively declined. Can you suggest a connection between these two developments?
15. List and describe institutions which regulate the international financial system.

16. Institutions that guarantee stability of the international financial system are unambiguously a good thing. Evaluate.

Empirical Evidence

17. We have seen that covered interest rate parity holds quite closely for deposits of differing currency denomination issued in a single financial centre. Why might covered interest rate parity fail to hold when deposits issued in *different* financial centres are compared?
18. International portfolios do not seem to be sufficiently diversified (*international portfolio non-diversification puzzle*). What are the main explanations for this? Are they fully satisfactory?