The Changing Environment of International Financial Markets

Issues and Analysis

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1 The Changing Environment of International Financial Markets: Introduction

Dilip K. Ghosh and Edgar Ortiz

The post-World War II era covering almost half a century has been continuously witnessing dramatic changes in the landscape of international finance as it relates to market structures, financial institutions and instruments. Since the conclusion of the Bretton Woods Conference with the inception of the International Monetary Fund (IMF) and the International Bank for Reconstruction and Development (IBRD or popularly known as the World Bank), the world has seen various developments in trade structures, investment designs, and the integration process. We have observed the emergence of the General Agreement to Borrow (GAB), test-tube monetary units or scrip currencies such as Special Drawing Rights (SDR), European Unit of Account (EUA), which later has become what is known now as the" European Currency Unit (ECU), stability (or lack thereof) in foreign exchange markets, different currency alignments under Eurosnakes and supermakes, FECOM (the French initial for European Monetary Cooperation Fund), European Monetary System (EMS),-and other regional monetary blocs. The world has become a global village; communication networks and the technological pace of progress have integrated international capital markets. Incredible growth of Eurocurrency and accessibility of financial operators in this market have made sovereign national monetary authorities less powerful in controlling and regulating the behaviours of economic agents in these days. The collapse of the Bretton Woods system, the liquidation of the Gold Pool, the introduction of free and dirty floats, the institution of international Banking Facilities (IBFs) by the United States, and so on have all contributed to the unavoidably developing trends in international financial markets, dictated hardly by any country, but certainly by hard calculations through financial engineering in international markets by way of arbitrage, hedging and speculation in national markets interconnected with each other by trading via telecommunications and computer networks. Ne w and changing political scenarios have also shaped the need and structures of international financial framework. The disappearance of the Iron Curtain through the demise of communist regimes in the Soviet Union and *in* its satellite states, the attempted marketization of those economies, the demolition of the Berlin Wall, and the reunification of Germany, the passage of the Maastricht Treaty, industrialization of ilm Pacific Rim Basin, the 'Big Bang' (creating progress towards around-the-clock trading), the establishment of SEAQ, the formation of the North American Free Trade Agreement (NAFTA), and so on have coloured as well as complicated the international picture of market environments and analytic frameworks. This is a sketchy history and a backdrop of the changing international financial markets. Within this market framework we have chosen the important issues and analyses thereof for this book.

Financial markets create values that contribute to corporate growth and profitability, and through the infrastructure of macroeconomic links, to domestic and international economic growth and development. Their efficiency and performance depend largely on complex interactions of institutional and market factors. Each one of them is in continuous change, and their interrelationships are in the mode of change as well as a result. International financial markets reflect such vicissitudes more than any other markets. During the last decade the international market environment has changed dramatically by a set of factors leading to greater internationalization and integration of world economic activities which we may call economic and financial globalization.

Technological progress in production has led to greater output, and differentials in technological changes have created differences in productivity and competitiveness among nations. A rapid expansion of trade and foreign direct and indirect investments, enhanced by technological changes, has induced internationalization of production. Multinational corporations have implemented global strategies in production, marketing and financing. Financial intermediaries have followed the trend, establishing 'full services' across borders to support trade and investments.

However, the potential of financial markets has been unleashed with economic liberalization and deregulation. Deregulation and financial liberalization have put down barriers that restricted the flow of capital across national borders. Restrictions on exchange rate« and capita] markets controls have been eliminated in many countries. Greater reliance has been placed on market forces to allocate capital and price the value of firms, Along with these factors, rapid pace in information and communication networks has contributed to accelerate the processes of data analysis and information dissémination. Moreover, fast-moving communication technologies have facilitated the trade of currencies and securities across national borders around ine clock, which has led to increased financial activities and enhanced arbitrage opportunities between markets.

The increasing globalization has been changing the fundamental characteristics of financial markets. As countries look to market forces to promote their developments, international barriers in trade, investments and capital flows fa-It, financial activities increase, and yet competition gets tougher in the global village. Similarly, markets become more sensitive to fundamental factors on a worldwide basis. This reflects in quick financial markets adjustments. Agents resort to more sophisticated techniques of analysis for decision-making in order to attain greater efficiency and manage systemic and exchange rate risks characteristic of transnational transactions. Simultaneously, financial intermediaries and governments improve market institutions, innovate securitization and portfolio management.

This new competitive globalized environment has led to greater interdependency among markets and nations. Accordingly, economic downturns and divergences on economic policies have frequently led to turbulence in the international financial markets, rapidly transmitting that from one market to another. Three major, often concurrent turbulences, can be identified in the age of financial globalization- First, the debt crisis of the 1980s. Imprudent borrowing and mismanagement of the domestic economy weakened the solvency of borrowing Less Developed Countries (LDCs). Private banks, which had pursued aggressive lending practices during the mid-1970s and early 1980s were severely affected, creating great instability and uncertainty in the financial markets. Second, securities markets plunged in October 1987. The event marked the influence of information flows on market performance. It did not result from changes in physical wealth, neither did it affect that. The ability to transmit market information around the world in seconds increased apprehensions about the market and the world economy. This led to unexpected chain reactions in plunging financial markets around the world. Understanding the nature of the 1987 stock markets crisis has helped prevent over-reaction. However, as global finance continues, it has become clear that financial markets are highly sensitive to information changes and flows, Their performance has continued to experience some recurrent commotions as responses to fundamental factors become more uniform and information about them spreads instantly. Finally, international financial markets have been characterized by periodic instabilities in the exchange markets, accompanied and fed by instabilities in interest and inflation rates. Currency fluctuations have reflected worldwide changes in competitiveness among nations, particularly in the industrialized ones. Competition among nations has increased to the point that many industrialized countries, particularly the United States, face huge deficits in trade balances which have contributed to deepen currency changes, as currency instabilities in the European Economic Community prove it. Institutional arrangements have been insufficient to promote exchange rate stability. Pressured by domestic problems, countries have resorted to independent monetary and exchange policies, which ultimately have led to regional and worldwide adjustments in exchange rates.

These negative trends have often reflected a lack of cooperation among nations and shortcomings of the international trade and monetary systems and institutions. Indeed, the failure of the GATT to solve differences of interests among the most developed nations has led to the emergence of an opposite trend in the international scenario: formation of strong economic blocs as an alternative to compete more advantageously in the globalized economy. Thus as the European Economic Community tightens its economic and financial ties among its members, in the Western Hemisphere Canada, United States and Mexico negotiate the North American Free Trade Agreement (NAFTA), while other Latin American countries are in the mode of instituting several integration schemes among themselves. Similarly, in Asia Japan leads integration among east Asian countries. Integration schemes concentrate on trade and investments, which influence international financial markets. Indeed, financial integration schemes are underway in the European Economic Community. By the end of the millennium the Community purports to have one common currency and unified monetary policy. Nevertheless, this pendular movement will tend to complement globalization and formation of economic blocs. Countries are associating themselves to increase their welfare by meeting the challenges of globalization from a more advantageous position. Thus, their environment will continue to be shaped by further globalization and economic integration schemes.

The dramatic changes in the environment of financial markets, as outlined, underlie the works presented in this book. Within this increasingly globalized financial market structure, international finance has increased its relevance as a theoretical and analytical discipline. It is growing and gaining ground every day. New researchers are pouring in with new issues, insights and analysis. Many of the old-age basic questions and analytical structures have already been extended to new horizons, and hence the depth and breadth of scope of critical examination of those concepts and issues have become inescapable necessities and realities. The chapters included in this book explore the basic building blocks of finance that must be promoted to push the potential of international financial markets.

Following this 'Introduction', Part II deals with markets of exchange rates. The works included in this part introduce new models and innovative research techniques to bring about insights concerning the dilemmas of long-run exchange rate equilibrium and market efficiency, and unrestrained market fluctuations *vis-à-vis* government intervention, left unsolved by conventional econometric models. These analyses have important implications for corporations and economic agents in general seeking to improve their exchange risk management to compete more effectively in the globalized economy.

Chapter 2 of this volume, 'Foreign Exchange Market Efficiency: A Look at London", by John P. Lajaunie, Bruce L. McManis and Atsuyoki Naka, attempts to determine long-run relationships existing between the price series of various currencies. Efficient market hypothesis in the semi-strong form is tested for the London foreign exchange market, using co integration techniques. Recent studies in the area of foreign exchange market efficiency have employed econometric techniques which test for the presence of long-run equilibrium relationships between the major currencies. The existence of such a relationship is a direct violation of the *efficient market hypothesis* and the existence of efficient speculative markets. In their study, the authors attempt to resolve the conflict in results found in prior empirical studies. The study also attempts to provide a limited generalization of the empirical results by extending the examination of market efficiency to an additional major foreign exchange market, London. Based on their tests, the authors conclude that the null hypothesis of the absence of a co integrating relationship cannot be rejected for any of the models specified, which confirms their results on speculative markets and the efficient market hypothesis.

The free Seating exchange rate system has come under heavy government intervention since the Group of Five intervention of 1985. In his chapter, 'Freedom of Free Floating Exchange Rate: Empirical Analysis of Currency Fluctuation Patterns' (Chapter 3), M. Ana am Hashmi examines fluctuations in selected currencies and determines whether fluctuations are a result of only market conditions or government intervention. The hypothesis of government intervention is rejected for most of the currencies, using daily exchange rates. However, findings are mixed for weekly and monthly data series. Therefore, Hashmi concludes that the foreign exchange market cannot easily be influenced by government intervention as market forces play a dominant role. Market signals should therefore be paid greater attention in the management of exchange risk exposure. Similarly, models designed for exchange rate management must give greater weight to market forces to avoid providing misleading signals, which has often been the case with current methods. Indeed, failure to take market forces adequately into account to measure exchange risk exposure can lead to disastrous business strategies. Firms and economic agents in general can fail to identify the instruments to hedge with and ensure their ability to fulfill their cash flow commitments. Since exchange markets are now truly international in scope, hedging techniques and instruments have also tended to become more universal. However, differences might arise, due to specific geographic, legal and cultural environments, and all these need to be identified and understood. The importance of this issue stands out in Chapter 3.

Part III explores international interest rates and underscores the importance of these rates in international financial markets. Eurocurrency and Treasury security interest rates have played a leading role in global financial transactions and global financial trends. Charles Maxwell and Larry Guin in their chapter, 'Statistical Analyses of Eurocurrency and Treasury Interest Rates from 1975 to 1991' (Chapter 4), examine the characteristics of each of these types of yields over the past 17 years. Moments around the mean, correlations between the markets, and other relationships are examined. Data analysed correspond to various types of US government securities on the one hand, and Eurocurrency interest rates on the other. The findings generally support the existing financial theory regarding the distribution of these yields. Examining subperiods of their 17-year period under analysis, the authors find no major changes in the moments around the mean. Correlations between both markets are high, confirming that money flows between both markets. Chapter 5, "A Cross-Country Comparison of Consumer Discount Rates[1], by William V. Weber, Jannett K, Highfill and Mathew j. Morey, sheds some more light on interest rates. This work develops a new theoretical foundation for estimating the consumer discount rate and applies the method by deriving some international comparisons of consumer discount rates. The chapter takes a micro-foundation of macro approach, starting off with an intertemporal optimum control problem. It is shown that the consumer discount rate can be derived from an economy's per capita growth rate, its real interest rate, and its marginal propensity to consume. In Chapter 6, 'The Interest Rate Parity, Covered Interest Arbitrage and Speculation Under Market Imperfection', Dilip K. Ghosh derives the expression of interest rate parity first in a perfect market, and then gives twelve additional expressions of interest rate parity under different scenarios of money market and foreign exchange market imperfections. The conditions for arbitrage profits and speculative opportunities are then spelled out.

Complementing the chapters on exchange rates and interest rates, and inflation, Part IV of the book deals with the balance of payments and international reserves, two fundamental factors that influence the changing environment of international finance. The common ground of the chapters in this section is the preoccupation of the authors for determining the impact of external deficits on future domestic and international activities. Aptly, the cases of developed and developing economies are analyzed, examining the cases of United States, the post-communist economies from Eastern European countries and the former Soviet Union, and a sample of small Latin-American countries.

Chapter 7 takes the issue of international reserves in a very timely fashion. Anisul N. Islam, Moosa Khan, and Mohammad M. Islam redefine in 'An Empirical Test of the Demand for International Reserves' the determinants and demand for international reserves under current financial market and world economic conditions. The chapter presents four theoretical models and estimates the demand function for international reserves for a sample of three Central American countries: Costa Rica, El Salvador and Panama, using econometric models and Box-Jenkins models. The overall estimation results are consistent with their models. However, the estimates made with the econometric model outperform Box-Jenkins models in terms of their ability to forecast reserve demands in the sample countries. The econometric model is reasonably stable over the 1960- -*89 period analyzed. It is worth noting, that contrary to some beliefs, the new international monetary system, based on flexible interest rates, had no impact on the reserves demand of the three Central American nations. Since econometric models clearly identify intervening variables in the determination of financial reserves, the logical implications of these findings are thai, for policy making, to shelter from possible instabilities of the balance of payments, econometric models are more useful.

Delving further in the fundamentals that influence the environment of international financial markets, Eric Youngkoo Lee and Michael Szenberg explore the US external sector. Its dramatic deficit increases during the last two decades and its change to a net debtor position has kept business activity under unparalleled strains, as the problem continues to grow and confrontation with its industrialized trading partners heats up. Many analytical proposals have attempted to shed some light into the problem emphasizing prospects and alternatives. Chapter 8, 'An Intertemporal Interpretation of the US Current Account Deficit', is a contribution along these lines. Opposing doomsday views, the authors present an optimistic diagnosis. They show, using a simplified intertemporal model of current account, that in so far as the government budget deficit represents the deliberate choice of policy-makers and therefore is taken as given, the alternatives the United States faces are higher levels of private investments and a trade deficit or low levels of private investment and balanced trade. Given the low US savings rate, the current account deficit should not be viewed as a problem, but rather as a solution to the problem of not having sufficient domestic savings to finance additional investment. Only part of the increased output and income generated by the additional investment spending accrues to foreign investors in the form of interests and dividend payments. The net inflow of capital from abroad will allow a faster growth in the US capital stock and a higher future standard of living than it would otherwise be. Their analysis is also positive because the authors identify market-oriented policies to eliminate the gap between savings and investment avoiding a 'hard landing' of the dollar and hence prevent undesirable turbulence in international financial markets. Chapter 9, 'Balance-of-Payments Implications of the Break-up of the USSR for its Former Republics and the East

European Countries', by M. Raquibuz Zaman takes a fresh Look into a new problem. The rise of market environment in the former Eastern European and ex-Soviet countries finds them with feeble financial institutions in need of sharp transformations before they can become an integral part of international markets. Their incorporation into the international financial markets is, however, imminent. Their transition can be enhanced by accelerating the changes needed in the real sector. This requires a thorough analysis abouf the changes taking place in the area of international relations of the post-communist economies. Trade is the point of departure, which is dealt by Zaman in this chapter. He points out that the economies of the East European countries and the former Soviet Union were not only based on a command structure of a centrally planned system, but also on a system of mutual cooperation and collaboration that manifested in barter trade of each other's merchandise. With the collapse of the system, each nation now faces the dual task of systematically dismantling the. old structure and erecting in its place a market-based system that can withstand competitive forces. Based on an analysis of past patterns of trade and the nature of underlying changes, the author contends that for some time to come the East European economies will face economic chaos and massive deficits in their balance of payments. However, it can be predicted that impacts of these deficits on the international financial markets will be negligible, although these initial impacts will tend to increase as integration of those nations with Western Europe and the rest of the world strengthens.

A somewhat similar situation but in a different dimension can be detected with respect to the developing countries. Although some developing countries are rapidly becoming integrated to world financial markets, many are experiencing difficulties in instituting reforms for their real and financial markets, and they remain cut-off from penetrating international markets. High debt payments and structural adjustments set back the economies of many developing countries during the 1980s to the point where the period has been identified as the Host decade'.. Recent negotiations, carried out under the Brady Plan, have eased off payments somewhat, allowing benefited countries to return to-their traditional growth patterns. However, the problem is far from "being solved. Debt levels are still high and in addition developing countries have built in a secular dependency on foreign borrowing, directly from syndicated banking institutions, or else through international capital markets. In addition many debtor countries have not ended negotiations to restructure their debt and their economies continue experiencing a negative economic downturn. International macroeconomic conditions are better now than in the late 1970s and early 1980s. Nevertheless, it is imperative to continue shedding more light on the origins and nature of the debt crisis to avoid its repetition. Country risk analysis also needs to be revisited to accede to new techniques that improve it and enhance banking practices in international lending.

Part V fills some of those needs. It examines foreign debt and country-risk analysis and sets forth new lessons from the debt crisis. In Chapter Í0, 'Foreign Exchange Dynamics, Debt and the "Peso Problem"', Dilip K. Ghosh presents the picture of Mexico suffering under gargantuan foreign debt, intractable rates of inflation and persistently plummeting value of the peso that has triggered a real and fundamental disequilibrium in which the policy makers and people have appeared totally helpless. In the chapter, it is pointed out that since relation between sovereign borrowers and sovereign lenders is like that of the partners in a three-legged race in which both can run, limp or fail together, but cannot part company, it is absolutely necessary and expedient for both Mexico and its lenders to agree upon a new schedule for loan amortization to their mutual benefit, if not for their immediate relief. Christopher A. Erickson and Elliott Willman, in 'International Lending and Sovereign Debt in the Presence of Agency Costs: The Case of Mexico" (Chapter 11), offer a powerful and novel analysis of, foreign debt by introducing agency costs in their model. It is shown that as long as some entrepreneurs are incompletely collateralized, the optimum government policy is to borrow the maximum possible amount from international lenders and transfer the proceeds to the private sector. It is further demonstrated that any reduction in government borrowing capacity results in a decline in domestic economic activities, and that decline does not end until the government rehabilitates its maximal borrowing capacity. Within the straitjacket of this analysis, Erickson and Willman examine the Mexican economy.

Identification of information asymmetries in international lending and debt capacity borrowing limitations capture the importance of improved country-risk analysis. Although sophisticated tools for country risk analysis have been developed during the last few years, international lenders still find it difficult to assess both the viability of a project in a developing country and, above all, the likelihood that unexpected events within a country weaken the ability of firms or the government to repay a loan. An aspect that needs further refinements concerns the criteria to be used. In Chapter 12, Ramakrsshnan S. Koimdinya deals with this problem in 'A New Look at Country Risk Analysis: An Analytical Approach to Judgmental Risk Scoring[1]. The author proposes the application of the *analytic hierarchy process* methodology to structure the judgmental scoring of country risk and evaluation of country risk profiles over time. He suggests a framework of analysis that enables incorporation of quantitative assessment of economic/financial performance and expert judgment on other qualitative factors. The preliminary model focuses on selected economic/financial variables for the evaluation of risk profiles, Conceptual attributes considered relevant in forming expectations about country risk exposure are defined for three hierarchy levels. Relevance of the model is confirmed with an application for a sample of selected developed and developing countries. In the next paper (Chapter 13), 'Political Risk in Latin American Stock Markets: A Rational Expectations Approach' Bench Carmichael, JeanClaude Cosset and Klaus P. Fischer investigate the impact of political risk on common stock returns of selected Latin American stock exchanges by taking a rational expectation approach on the relationship between the government policy menu and prices of securities in these stock exchanges.

One of the most profound changes in the environment of financial markets has been the globalization of securities markets. During the last decade international capital markets underwent an explosive growth. Simplification and harmonization of major stock exchanges taking place concurrently led to higher competition and important innovations in securitization and intermediation. These changes promoted intense cross-border equity and bond financing. However, growth of the securities markets was heavily influenced by unfavorable international conditions making their environment unstable and risky. We have also witnessed the adoption of financial deregulation and liberalization which linked markets even further and forced corporations to globalize financing of their investments.

Looking at these problems, Part VI takes an analytical look at capital markets and makes important extensions of modern investments and portfolio theory as well as agency theory to take into account increased international competition and globalization of financial markets. Patterns of changes in the international capital markets are examined to determine their efficiency; conventional paradigms and research techniques are extended to test global efficiency and formulate new theories and tests for the case of emerging capital markets. The issues have attracted the attention of practitioners and researchers, but disagreements remain on the nature of global exchange markets. One point of concern refers to the degree of integration among international stock exchanges and their ability to process information. Shahriar Khaksari and Neil Seitz conduct new tests to answer this question, in Chapter 14, [4]A Real Return Test of International Market Efficiency", the authors aim at determining whether the mean-variance frontier available to an internationally diversified investor is affected by the choice of the country in which ultimate consumption is to occur. Limitations of previous studies are overcome by including dividends as well as price changes in computing equity returns, by including long and short-term debt securities as well as equity, and by adjusting returns for inflation so that both real and nominal return efficient frontiers could be examined. Empirical findings show that the location of the mean-variance efficient frontier is affected by the country in which ultimate consumption takes place. The chapter therefore provides evidence that international capital markets are not fully integrated.

Financial globalization has mainly taken place among the leading industrialized countries. Nevertheless, developing countries have also been impacted by financial innovations around the world and are rapidly assimilating to the new international financial markets structures. Moreover, in the aftermath of the debt crisis, developing countries have been seeking alternative ways of financing. Consequently, to mobilize international savings to their markets, they have adopted ambitious economic reform programmes, including deregulation and liberalization of their financial markets. Free from the bonds of government, their financial markets seem to be bursting and are 'emerging' as an important part of world financial activity. However, they are still characterized by imperfections that pose a big challenge to overcome them. Unfortunately, understanding of these 'emerging markets' remains limited, and theories to explain their behavior and relationships with the real markets are non-existent. Moreover, finance theory has not been extended to take into account market imperfections found in the developing countries. One important fact, which restrains the growth of financial markets, is the existing forms of organization and governance of firms in the developing countries. Firms remain largely family-owned, with little or no stocks sold tn financial markets. Klaus P. Fischer, Edgar Ortiz, and A. P. Palasvirta make an important contribution in this direction. In their chapter, “Risk Management and Corporate Governance in

Imperfect Capital Markets" (Chapter 15), Fischer, Ortiz and Palasvirta explicate the issues concerning corporate governance and risk management under imperfect capital markets. Finance theory commonly explains these issues in terms of perfect capital markets. The authors present an alternative paradigm to take into account the case of entrepreneurs taking their decisions in the absence of arms' length capital markets. Based on this conceptual framework and previous empirical! studies, these authors conclude that in the absence of developed financial markets where risk can be bundled and price of the corporation is fair, owner-managers have no incentives to relinquish control and diversify risk through financial markets. They present and discuss three propositions about corporate control and risk management by owner managers in the developing countries. They also identify the reasons underlying the existence of 'industrial groups' — a sort of family-owned conglomerates - and the set of opportunities that under imperfect financial markets, entrepreneurs have to invest and diversify risk, particularly high systematic risk associated with 'political risk' derived from excessive state interventionism in the economy. Four strategies used by owner-managers to diversify risk are identified and discussed: export capita] (international diversification); diversify in the real sector through atomized projects — firms — which leads to the creation of groups; leverage up through group-owned financial intermediaries; and generate rents through permanent monopoly profits, often resulting from distorted government practices. The propositions presented by the authors have important implications for capital market development. They identify some distortions from the real and financial markets that must be dealt with to enhance their expansion and integration with world financial markets so that their contributions to development are optimized. Concretely, governments should induce changes in the supply and demand side of the capital markets so that corporations find it attractive to become public, and investors find adequate diversification opportunities due to the existence of an attractive frontier of risk return alternatives. However, changes in the financial markets must go along with changes in the real markets. Lesser intervention of the state in the economy should be enforced to eliminate monopoly profits which due to government intervention are not transient in nature, like in common corporate entrepreneurship, but permanent and do distort the potential growth of corporations and the economy.

These implications are finely exemplified by the South Korean case — also an emerging financial market. Although liberalization of its financial markets has been considered exemplary, some limitations are becoming apparent. Joanna Poznanska makes this point in Chapter 16. 'Structural Changes in the Korean Financial Market', She shows that South Korea has reached the stage of industrial maturity without a developed financial system, and then she analyses reforms implemented in the banking system and the securities markets, and identifies the nature of Korean financial internationalization. These analyses lead her to assert that to sustain further growth Korea will have to adopt various types of liberalization policies. The essence of needed reforms lies in the activation of market competition through divestment of state assets and deregulation of financial markets. By freeing interest rates in the financial markets the government hopes that interest rate will reflect availability of funds. To promote corporate growth, the government has opened the local stock market to foreign investors. Korean government intervention aims to strengthen the market to enable it to become the regulating force of the economy. However, the government intends to pursue reforms slowly, in a gradual fashion, but market forces may overtake the process. The main targets of the reform,, the *chaebol*, the Korean family firm, and the commercial banks are finding it difficult to adjust to proposed changes. In conclusion, Poznanska argues for furthering financial and real reforms in Korea as the means to ensure its continued economic growth.

An important feature of the new financial environment is the emergence of equity markets of quotation systems. In Chapter 17, 'An Analysis of Equity Markets of Quotation Systems', Gitles Duteil and Abraham Mulugetta provide a useful exposition and examination of equity markets, highlighting the operational efficiency, liquidity, and other 'qualities'. They bring out the French market microstructure of the Paris Bourse's continuous quotation system that has been inspired by the Toronto Stock Exchange CATS system and make a number of useful observations on liquidity and depth. It is concluded that actual market organization does not seem to be suitable for bloc trading (except OTC) and for future growth of harmonization of financial services in Europe. It is contended further that the active competition of the London SEAQ international market in which most of the French 'blue chips' are traded by market makers is likely to increase since it provides a firm price and immediacy to block traders.

One important reason why international financial markets find restraints to their integration is differences in tax systems among nations. The international financial environment is continuously influenced by changes in the treatment to corporate dividends and capital gains. Similarly, restrictive tax systems have tended to distort capital markets development at the domestic level. On the other hand, increased globalization is firmly leading the way towards greater harmonization of tax laws. Fart VII of the book brings out tax issues and models of tax structure under closed and open economies, and examines various facets of this type of price distortion, discusses the implications of existing municipal taxation systems in Mexico on the North American Free Trade Agreement. In this part, focus is also put on international banking globalization. Historical patterns of globalization of the French banking system and the details of offshore banking trends are examined. Alejandra Cabello's 'Economic Integration and Mexican Municipal Finances' (Chapter 18) attempts to study the implications of existing municipal taxation systems in Mexico on the North American Free Trade Agreement (NAFTA). She puts forth an important point: potential benefits to Mexico from its integration with Canada and the United States might be limited due to existing asymmetries among the three nations. Uneven regional development is a factor that could create severe bottlenecks in the North American integration processes, hindering Mexico's trade and investment opportunities that could be gained from the NAFTA. This conclusion is reached after a careful analysis of Mexican municipal finances. To this effect, she first reflects on the interrelationships between economic integration and municipal development and finances. She argues for more resources and greater autonomy in municipal taxation as a means to promote 'grass root' development. Her empirical analysis corroborates this assertion. In the long run, she finds, municipal revenues tend to decrease in real terms and Federal revenue shares become the most important source of local revenues, amounting to nearly 70 per cent of Mexican municipal funds. The problem can be identified with a weak federalism leading to a strong intervention by the central government in local economic activity. Poor training in municipal management and Lack of adequate accounting systems also account for this problem. For this reason Cabello proposes an accounting system for municipalities, based on private accounting, and some policies to decentralize public municipal finances. The author also proposes a forward looking attitude in these policies so that harmonization with its Northern trade partners can be achieved at all levels of taxation. In the context of an international financial markets, the implications of this study are straightforward.

In a nation, financial markets can only flourish if its economy is fully integrated. Similarly, outward financial integration cannot succeed, or at least will be .limited in scope in the absence of arm's length well integrated financial markers in one of the participant countries.

Another angle of taxation is explored in Chapter 19, Alternative tax structures in closed and open economy frameworks are model led and discussed by Dilip K. Ghosh and Shyamasri Ghosh in 'Optimum Distortions in Closed and Open Economies: Some Aspects of the Theory of Second Best'. Their point of departure is the search by policy makers for optimum economic policies in an impcrfect market environment. The issue has been brilliantly dealt with in the literature of 'second best', but researchers have failed to present a coherent structure of optimum distortions. Ghosh and Ghosh tackle this problem. They determine the structure of optimum distortions in different postulated set-ups, and discuss the issues on possible tax structure in closed and open economic frameworks. Then, the authors attempt to ascertain when uniform rather than differentiated and when differentiated rather than uniform tax structure would be optimal for the taxing country. Many other results in the area of 'second best' are reviewed and extended, looking up at the problem of tariff manipulation. In this context, the authors provide conditions for successful trade liberalization and creation of trading blocs and customs unions. In the emerging environment of economic integration such as the European Monetary System (EMS), the North American Free Trade Agreement (NAFTA), and the like, if or when removal or reduction of tariffs is called for, and in the event that is warranted, what the structure of elimination or reduction ought to be has been enunciated in this work within the framework of welfare maximization. In Chapter 20, 'Socio-History of French Banks and Banking: Role Model for Global Banking', Irene Fine! Honigman turns to historical evidence to assess patterns of internationalization and draws lessons to the present banking internationalization. The author finds that fear of speculation and risk since the financial fiascos of the eighteenth century coupled with a sense of historical presence and cultural identity have led France to adopt long term, well hedged protective policies while developing and maintaining vast inter-country and international banking networks. French banking has always depended on effective government intervention from Napoleon III 'Saint Simonien' capitalism (1860-71) to de Gaulle's nationalization of major banks (1946) to Mitterrand's complex manoeuvres from nationalization to privatization (1981-88).

A specific study of the Crédit Lyonnais's role from its inception in 1863, its foreign subsidiaries following the Franco-Prussian war, its presence as global bank, illustrates the paradoxical nature of government control and capitalist initiative. French banks dominated world markets through networks of branches, representative offices and foreign investment. She contends that at a time when we note a sense of crisis in the domestic American banking system and the emergence of unified monetary markets and economic hyper structures in Europe, France's historical experience will help her io play a leading role in the European Monetary Union (EMU), and the promotion of a Euro Fed will continue to help shape the future of global banking policies.

Aggressive and innovative banking management has led to a higher degree of competition in international banking. To enhance their competitiveness, US banks have established offshore banking centres to strengthen their international operations. Offshore centres allow them to lower costs and overcome limitations due to tax laws or regulatory policies meant to ensure sound banking management and confidence on the financial system. As a result, US banks carry out a significant amount of foreign lending activities through offshore banking centres. In the last chapter of this book, "Offshore Banking Centres: Prospects and Issues' (Chapter 21), Emmanuel Roussakis, Krishnan Dandapani and Arun Prakash focus on the main issues surrounding this international banking practice. They present the environment of offshore banking and explicate the problems thoroughly, and then shed some light on its prospects. They conclude with their significant empirical analysis that barriers all over the world are crumbling and the world is becoming a global market place. In this changing environment of international financial markets the offshore banking centers which can provide excellent quality of service and can maintain high regulatory and supervisory standards can be expected to survive in decades to come, and this requirement will in turn strengthen the banking system worldwide.

This book thus presents a wide spectrum of the analytical as well as empirical examination of several developments in our changing environment of international financial markets. As time moves forward, new developments will take shape, new problems will surface, and new challenges will be met. This work will be a guide for confronting some of those upcoming events, and we will also learn on the way to restructure and modify our analytical skill, theoretical frameworks and empirical designs to cope with the new situations and scenarios.

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