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0521632730 - Currency Competition and Foreign Exchange Markets: The Dollar, the Yen and the Euro

Philipp Hartmann

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## Currency Competition and Foreign Exchange Markets

*The Dollar, the Yen and the Euro*

*Currency Competition and Foreign Exchange markets* by Philipp Hartmann is a major new theoretical and empirical study of international currencies, which focuses on the role which the euro (the future single European currency) will play, along with the US dollar and the Japanese yen, in the international monetary and financial system.

In contrast with much of the existing literature, which approaches the subject from a macroeconomic perspective, Hartmann develops theoretical and empirical models which use game theory, time series and panel econometrics, and link financial market micro-structure analysis with transaction cost economics. The results of *Currency Competition and Foreign Exchange Markets* are presented with reference to political, historical and institutional considerations, and provide accessible answers for policy-makers, business people and scholars world-wide. The sections on spread estimation and multiple vehicles with inter-dealer price and entry competition will be of particular use for finance professionals.

is an economist at the European Central Bank in Frankfurt. He formerly worked in the Financial Markets Group at the London School of Economics. He is widely regarded as one of the leading young economists in Europe, and his work has been featured on BBC Radio 4 (UK) and in publications including *Le Figaro* (France), *The Wall Street Journal* and the *Frankfurter Allgemeine Zeitung – Blick durch die Wirtschaft* (Germany). His previous writings include the monograph *Financial Regulation: Why, How and Where Now?* (with Professor Charles Goodhart *et al.*) and numerous articles published in leading academic and policy journals.

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## Preface and acknowledgements

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When I started working on international currencies in 1992 the Maastricht Treaty, establishing a concrete timetable for the completion of European Economic and Monetary Union (EMU), had just been signed. Many citizens, economists, journalists and politicians, in particular in the United States but also in Europe, remained sceptical whether such an ambitious project would ever go ahead, and most people pondered what the internal consequences for Europe would be and whether EMU was really such a good idea. In this situation, only a limited number of people, most of them within or close to the European Commission, found it worthwhile to think about ‘great ideas’, such as the external role of the single currency and its future competition with the US dollar. Fascinated by the idea of ‘getting under the skin’ of the workings of the world monetary and financial system, I began to wonder whether I could tackle this issue with modern economic analysis.

It was at that time that I met Richard Portes, who was one of the few academics recognizing the political determination in Europe to bring EMU into being and who was prepared to make ‘the great leap forward’ necessary to think about the implications for the international monetary order. He encouraged me to start a long-horizon theoretical and empirical research programme on the determinants of international currencies in general, which could alleviate the lack of rigorous analysis in this field and also satisfy a great deal of demand once the introduction of the single currency was imminent. The time has now come; when this book is available in bookstores the introduction of the euro will only be a couple of months away. The book is the synthesis of my work in this area over the last couple of years: however speculative the predictions in the applied parts may sound to some readers, I hope that it helps reduce the uncertainty and confusion about what the likely consequences of EMU will be for the international monetary and financial system.

The first person I would like to thank is Richard Portes, who – since Summer 1992 in Paris – followed my work in this area closely and did not spare suggestions, criticism and support for my projects. Most of the

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work was done while I was on the staff of DELTA (Ecole Normale Supérieure, Paris) and of the London School of Economics' Financial Markets Group (FMG). I would like to express my gratitude to Roger Guesnerie and François Bourguignon, and David Webb and Charles Goodhart as well as to my other colleagues from DELTA and the FMG for the stimulating research environments they provided. Financial support by the EU Commission's Human Capital and Mobility Programme and by the UK's Economic and Social Research Council (ESRC) is gratefully acknowledged.

Among the other researchers who have expressed an interest in the various projects contained in this book I would like to mention explicitly Christian de Boissieu (Université Paris I, Panthéon-Sorbonne), Bernard Dumas (HEC), Jürgen von Hagen (Bonn University), Torsten Hens (Bielefeld University) and Charles Wyplosz (University of Geneva), who with their suggestions and criticism have helped improve substantially some of the more technical aspects. I have also greatly benefited from discussions with Roel Beetsma and Peter Schotman at Limburg University; Stanley Black at the University of North Carolina; Marc Flandreau at OFCE; Rüdiger Frey at ETH, Zurich; Paul de Grauwe at Leuven University; Dominique Guillaume at Oxford University; Nobuhiro Kiyotaki at the University of Minnesota; Michael Leahy and Shang-Jin Wei at Harvard University; Ward Brown, Charles Goodhart, Asbjørn Hansen and Richard Payne at LSE; Guillermo Larraín, Thierry Magnac, Mathilde Maurel, Georges de Ménil, Nathalie Picard, Gilles St Paul and Bertrand Villeneuve at DELTA; Alvaro Almeida, Peter Clarke, Peter Quirk, George Tavlas and Jens Weidmann at the IMF; Michel Dacorogna, Rakhil Davé, Ueli Müller and Richard Olsen at Olsen & Associates; Ann Fremault-Vila and Dirk Schoenmaker at the Bank of England. Another indispensable input were the discussions I had with market economists and traders, in particular Francis Breedon of Lehman Brothers, Jean-Christophe Doittau of Compagnie Bancaire, Michael Feeney of Sumitomo and Dirk Wegener of Citibank.

Some sections of chapter 4 were first presented at the Centre for European Policy Studies' (CEPS) working party on 'The Passage to the Euro' (May 1996); I am grateful to the Chairman, Helmut Schlesinger, and the two Rapporteurs, Daniel Gros and Karel Lannoo, for having given me this opportunity and to all the working party members for a lively debate on this occasion. Parts of the book have also been presented at academic conferences and seminars too numerous to list in this Preface.

For the empirical parts of the book I had to gather a substantial amount of very specific data. Without the extraordinary cooperation of

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Olsen & Associates and a large number of central banks this would never have been possible. It is therefore a pleasure to mention the hospitality of Olsen & Associates in Zurich, where I spent one month in the research group. In particular, Rakhal Davé assisted me generously in the use of Olsen & Associates' high-frequency foreign exchange data bases. Thanks go also to Ashwin Rattan of Cambridge University Press, who has taken so much care of the manuscript. Last but not least, my readers and I owe a lot to the anonymous subway driver who found my notebook and diskette with the complete manuscript of the book.

The manuscript was finalized while I was on the staff of the London School of Economics' Financial Markets Group. Any views expressed are solely my own.

*London, September 1997*