List of Figures		xv
List of T	Tables	xvii
List of E	Boxes	xx
Preface		xxi
90 O	vledgements	xxiv
ACKNOW	vicugements	AAI
1 The	World of Finance	1
1.1	Introduction	2
1.2	Financial centres	3
1.3	The role of a financial centre	3
1.4	Money markets, capital markets and the banking system	5
1.5	Services of a financial centre	6
1.6	The growth of the financial services industry	9
1.7	The globalization of financial markets	10
1.8	Technology	11
1.9	Deregulation	13
1.10	Financial innovation	14
1.11	Types of financial innovations	18
1.12	Emerging markets	18
1.13	Problems concerning investment in emerging markets	21
1.14	The future	22
1.15	Conclusions	24
2 Fin	ancial Intermediation and Financial Markets	26
2.1	Introduction	27
2.2	Surplus and deficit agents	27
2.3	What is a financial security?	28
2.4	Types of financial claims: debt and equity	28
2.5	The role of financial intermediaries	29
2.6	Provision of a payments mechanism	30
2.7	Maturity transformation	30
2.8	Risk transformation	30
2.9	Liquidity provision	31
2.10	Reduction of contracting, search and information costs	32
2.11	Types of financial markets	32
2.12	The classification of financial markets	34

	2.13	The role played by financial markets	3
	2.14	Participants in financial markets	3
	2.15	Conclusions	3
3	Fina	ncial Institutions	39
	3.1	Introduction	4
	3.2	The central bank	40
	3.3	The implementation of monetary policy	4
	3.4	Management of the national debt	4
	3.5	Supervisory function	4
	3.6	Types of financial intermediaries	4
	3.7	Deposit institutions	4
	3.8	The banking sector	4
	3.9	Savings institutions	4
	3.10	Insurance companies	4
	3.11	The phenomenon of Bancassurance	50
	3.12	Mutual funds or unit trusts	5
	3.13	Investment companies and investment trusts	52
	3.14	Exchange traded funds	53
	3.15	Pension funds	5
	3.16	Hedge funds	56
	3.17	Private equity	57
	3.18	Specialist financial institutions	60
	3.19	Venture capital companies	6
	3.20	Finance companies or finance houses	6
	3.21	Factoring agencies	62
	3.22	The role of financial institutions	62
	3.23	Conclusions	65
4	Mon	etary Policy and Interest Rate Determination	67
	4.1	Introduction	68
	4.2	The functions of money	68
	4.3	Bills and bonds	69
	4.4	The operation of monetary policy	70
	4.5	Monetary policy in practice and the announcement effect	73
	4.6	The commercial banking system and the narrow and broad money supply	75
	4.7	Formula for the money multiplier	77
	4.8	Controlling the money supply	78
	4.9	The determination of interest rates	79
	4.10	The loanable funds approach to interest rate determination	81
	4.11	Money market or loanable funds theory?	83
	4.12	Inflation and interest rates	83
	4.13	Fiscal policy and interest rates	85
	4.14	Other factors influencing the interest rate	86
	4.15	Theories of the yield curve	86
	4.16	Expectations theory	87
	4.17	Liquidity preference theory	89
	4.18	Preferred habitat theory	90

	•
	А.

	4.19	Market segmentation theory	90
	4.20	The importance of alternative views of the term structure	91
	4.21	Problems with monetary policy	91
	4.22	Conclusions	92
5	Dom	estic and International Money Markets	94
	5.1	Introduction	99
	5.2	Types of domestic money market instruments	95
	5.3	Treasury bills	95
	5.4	Commercial paper	97
	5.5	The interbank market	97
	5.6	Banker's acceptances	100
	5.7	Repurchase agreements	101
	5.8	Certificates of deposit	101
	5.9	The international money market	102
	5.10	Euromarkets	102
	5.11	The origins and development of the Euromarkets	102
	5.12	The characteristics of the Eurodollar market	104
	5.13	The competitive advantage of Eurobanks	106
	5.14	The coexistence of domestic banking and Eurobanking	108
	5.15	The creation of Eurodeposits	109
	5.16	The pros and cons of the Eurocurrency markets	110
	5.17	Syndicated loans	110
	5.18	Euronotes	111
	5.19	Conclusions	112
6	The I	Domestic and International Bond Market	114
	6.1	Introduction	115
	6.2	Trading in government bonds	115
	6.3	Determining the price of government bonds	116
	6.4	Clean and dirty bond prices	117
	6.5	The current yield	117
	6.6	The simple yield to maturity	118
	6.7	Yield to maturity	118
	6.8	The par value relation	119
	6.9	Bond price volatility	121
	6.10	Duration	122
	6.11	Modified duration	123
	6.12	The duration for a portfolio of bonds	125
	6.13	A formula to calculate duration	126
	6.14	Duration and the problem of curvature of the bond-price relationship	126
	6.15	The usefulness of the duration measure	127
	6.16	Yield curves	128
	6.17	Corporate bonds	128
	6.18	Credit ratings	129
	6.19	Risks associated with corporate bonds	133
	6.20	Financial innovation and corporate bonds	133
	6.21	lunk bonds	135

	6.22	Medium-term notes	130
	6.23	The international capital market	130
	6.24	Motivations behind international capital flows	137
	6.25	The origins and development of the Eurobond market	137
	6.26	Typical features of a Eurobond	138
	6.27	Control and regulation of the Eurobond market	140
	6.28	The management of a Eurobond issue	140
	6.29	Innovations in the Eurobond market	142
	6.30	Conclusions	144
7	00000000000	folio Analysis: Risk and Return in Financial Markets	147
	7.1	Introduction	148
	7.2	Determining the price of a financial asset	148
	7.3	The rate of return on a security	149
	7.4	The variance and standard deviation of the rate of return	150
	7.5	Risk on a security	151
	7.6	Covariance and correlation of rates of return	152
	7.7	Different types of investors	153
	7.8	The indifference curves of risk-averse investors	154
	7.9	Portfolio theory	155
	7.10	Reducing risk through diversification	155
	7.11	Measuring risk on a portfolio	156
	7.12	The two-asset efficiency frontier	158
	7.13	The minimum variance portfolio in the two risky assets case	159
	7.14	The portfolio efficiency frontier	160
	7.15	Market risk and specific risk	163
	7.16	The efficient set with a riskless security	165
	7.17	The market portfolio	166
	7.18	The market price of risk	168
	7.19	Measuring the market index	168
	7.20	Conclusions	169
8	The G	Capital Asset Pricing Model	172
	8.1	Introduction	173
	8.2	The market model	173
	8.3	Portfolio risk and return using the market model	175
	8.4	The capital asset pricing model	176
	8.5	Assumptions of the CAPM	176
	8.6	The theory behind the CAPM	177
	8.7	Expressing the CAPM in risk premium form	179
	8.8	The securities market line	180
	8.9	The CAPM in action: measuring the beta coefficient	182
	8.10	Empirical testing of the CAPM	184
	8.11	The empirical evidence on the CAPM	188
	8.12	The multifactor CAPM	189
	8.13	The arbitrage pricing theory (APT) critique of the CAPM	190
	8.14	Conclusions	191

9	Stock	markets and Equities	195
	9.1	Introduction	196
	9.2	The major international stockmarkets	196
	9.3	Stockmarket participants	199
	9.4	The primary and secondary markets	199
	9.5	Different types of equity	200
	9.6	The buying and selling of shares	203
	9.7	A rights issue	203
	9.8	A simple model of the pricing of a rights issue	206
	9.9	Does the performance of the stockmarket matter?	206
	9.10	The pricing of equities	207
	9.11	The dividend pricing approach	208
	9.12	The Gordon growth model	208
	9.13	A non-constant growth version of the dividend discount model	210
	9.14	The dividend irrelevance theorem	211
	9.15	Measurement of the required rate of return	211
	9.16	The subjectivity of share pricing	212
	9.17	Forecasting future dividends: business risk and the effects of gearing	213
	9.18	Debt or equity finance?	218
	9.19	Other approaches to equity valuation: financial ratio analysis	219
	9.20	The usefulness of financial ratios	223
	9.21	Conclusions	224
10	The E	fficiency of Financial Markets	227
	10.1	Introduction	228
	10.2	Three levels of efficiency	229
	10.3	The efficient market hypothesis and a random walk	229
	10.4	Implications of various forms of efficiency tests	231
	10.5	Active versus passive fund management	232
	10.6	Testing for weak market efficiency	232
	10.7	Tests of the random walk hypothesis	232
	10.8	Filter rule tests	232
	10.9	Other statistical tests	234
	10.10	The day-of-the-week effect	234
	10.11	The January effect	234
	10.12	The winner-loser problem	235
	10.13	Testing for semi-strong market efficiency	236
	10.14	The results of event studies	240
	10.15	The size effect	241
	10.16	The price-earnings effect	241
	10.17	The earnings-announcement effect	241
	10.18	Stockmarket crashes	242
	10.19	Testing the strong form of market efficiency	243
	10.20	Directors'/managers' share purchases	243
	10.21	Information content of analysts' forecasts	243
	10.22	Conclusions	244

11	The	Foreign Exchange Market	246
	11.1	Introduction	247
	11.2	Exchange rate definitions	247
	11.3	Characteristics of and participants in the foreign exchange market	248
	11.4	Arbitrage in the foreign exchange market	250
	11.5	The spot and forward exchange rates	252
	11.6	A simple model for determining the spot exchange rate	254
	11.7	Alternative exchange rate regimes	257
	11.8	Determination of the forward exchange rate	263
	11.9	Nominal, real and effective exchange rate indices	266
	11.10	Conclusions	273
12	Theo	ries of Exchange Rate Determination	275
	12.1	Introduction	276
	12.2	Purchasing power parity theory	277
	12.3	Absolute PPP	277
	12.4	Relative PPP	278
	12.5	Measurement problems in testing for PPP	278
	12.6	Empirical evidence on PPP	280
	12.7	Summary of the empirical evidence on PPP	285
	12.8	Explaining the poor performance of purchasing power parity	285
	12.9	Modern theories of exchange rate determination	287
	12.10	Uncovered interest rate parity	287
	12.11	Monetary models of exchange rate determination	288
	12.12	The flexible price monetary model	289
		The Dornbusch sticky price monetarist model	293
		A simple explanation of the Dornbusch model	293
		A formal explanation of the Dornbusch model	295
		A money supply expansion and exchange rate overshooting	298
		Importance of the Dornbusch overshooting model	300
		The Frankel real interest rate differential model	300
	12.19	Conclusions	303
13	Finar	ncial Futures	305
	13.1	Introduction	306
	13.2	The growth of futures exchanges	306
	13.3	Comparison between futures and forward contracts	307
	13.4	Exchange traded derivative contracts versus the over-the-counter market	309
	13.5	Trading in exchange futures contracts	309
	13.6	The role of the clearing house	310
	13.7	Open interest and reversing trades	310
	13.8	Stock index futures	311
	13.9	The symmetry of profits/losses on futures/forward positions	316
	13.10	The pricing of stock index futures	318
		Short-term interest rate futures	319
	13.12	The pricing of a Euribor interest rate futures contract	321
		Using interest rate futures	322

	13.14	Bond futures contracts	323
	13.15	Currency futures	325
		The pricing of currency futures	326
	13.17	Conclusions	327
14	Opti	ons	330
	14.1	Introduction	331
	14.2	The growth of options markets	331
	14.3	Options contracts	331
	14.4	A call option contract	332
	14.5	A put option contract	334
	14.6	Stock index options	337
	14.7	Interest rate options	338
	14.8	Currency options	339
	14.9	The uses of options contracts	340
		Differences between options and futures contracts	342
		A currency option versus a forward contract for hedging	342
		A currency option versus a forward contract for speculating	344
		Options strategies	345
		Exotic options	348
	14.15	Conclusions	349
15	Opti	on Pricing	352
	15.1	Introduction	353
	15.2	Principles of option pricing	353
	15.3	Intrinsic value and time value	354
	15.4	The distribution of the option premium between time and intrinsic value	355
	15.5	The Black-Scholes option pricing formula	359
	15.6	Different measures of volatility	363
	15.7	The calculation of historical volatility	363
	15.8	Problems with the Black-Scholes option pricing formula	365
	15.9	The sensitivity of options prices	365
	15.10	Put-call parity	366
	15.11	Conclusions	369
16	Swap	Markets	373
	16.1	Introduction	374
	16.2	Potential swap scenarios	374
	16.3	An interest rate swap	377
	16.4	A currency swap agreement	380
	16.5	The role of the intermediary in the swap	384
	16.6	The secondary market in swaps	385
	16.7	Distinguishing characteristics of the swap market from the forward	
		and futures markets	386
	16.8	Reasons for the existence of the swap market	387
	16.9	Innovations in the swap market	387
	16.10	Conclusions	388

17	Finai	ncial Innovation and the Credit Crunch	390
	17.1	Introduction	391
	17.2	Financial innovation: collateralized debt obligations and credit default swaps	392
	17.3	Special purpose vehicle/special purpose entity	395
	17.4	A structured investment vehicle	396
	17.5	Credit derivatives and credit default swaps	397
	17.6	The pricing of credit derivatives	403
	17.7	The credit crunch	405
	17.8	Causes of the credit crunch	408
	17.9	Legislative changes and deregulation	408
	17.10	Deterioration in bank lending standards and adverse selection	411
	17.11	Increase in household indebtedness	412
	17.12	Financial innovation and the credit rating agencies	413
		Increased leverage in the financial system	413
	17.14	Mispricing of risk	414
	17.15	Incentive structures and risk management practices in the banks	415
	17.16	The response to the credit crunch	416
	17.17	Cuts in official short-term interest rates	419
	17.18	Liquidity provision	419
	17.19	Quantitative easing	421
	17.20	Fiscal stimulus	422
	17.21	Bailouts of financial institutions	423
	17.22	Bank stress tests	424
	17.23	Regulatory response	426
	17.24	The UK response	429
	17.25	Fines	434
	17.26	Conclusions	435
18	Regu	lation of the Financial Sector	439
	18.1	Introduction	440
	18.2	The rationale for government intervention	440
	18.3	The objectives of government regulation	442
	18.4	Types of government regulation	442
	18.5	Regulation of the banking sector	444
	18.6	Statutory regulation versus self-regulation	446
	18.7	Regulation in the UK	446
	18.8	Big bang, 1986	447
	18.9	The Financial Services Act 1986	448
	18.10	The Banking Act 1987	449
	18.11	The Bank of England Act 1998	449
	18.12	Financial Services and Markets Act 2000	450
	18.13	Banking Act 2009	450
	18.14	The Financial Services Act 2013	450
	18.15	European regulation	452
	18.16	The First Banking Directive 1977	454
	18.17	The Second Banking Directive 1989	455
	18.18	The creation of a European Banking Union	455