Editorial

Sushanta Mallick

School of Business and Management,
Queen Mary, University of London,
Mile End Road,
London E1 4NS, UK
E-mail: s.k.mallick@qmul.ac.uk
Website: http://webspace.qmul.ac.uk/skmallick/

Biographical notes: Sushanta Mallick is a Professor of International Finance at the School of Business and Management, Queen Mary University of London, UK. Prior to being at Queen Mary, he held positions at Loughborough University, UK, Royal Institute of International Affairs (Chatham House), London, and JPMorgan Chase (previously Chase Manhattan Bank) based in Hong Kong. He holds a PhD in Economics from the University of Warwick, UK. In addition to publishing a book from his PhD research (Ashgate Publishing, 1999), he has contributed papers to eight edited volumes along with publishing widely in many international refereed journals. His main research interests include issues in international macroeconomics and finance.

This special issue of the *International Journal of Monetary Economics and Finance* (IJMEF) includes six papers on applied issues in international money and finance in the context of advanced and emerging markets. They were selected through a peer-review process from papers presented at the 9th Annual Meeting of the European Economics and Finance Society (EEFS) International Conference, held in Athens, Greece, during 3–6 June 2010, with a few invited papers. The set of papers included in this special issue focus on international macroeconomic and financial issues. In the light of the recent financial crisis, understanding how financial shocks get transmitted across countries, and analysing the structural and behavioural channels of shock transmission are critical for policy design.

Thorough understanding of the problems must precede any concrete proposal for solutions. The key topics discussed here include factors driving inflationary pressures in emerging markets, exchange rate dynamics, transmission of financial shocks, causes of financial distress, and behavioural approach to finance, thus contributing towards building up of a strong foundation for understanding different shocks in advanced and emerging markets.

The first paper brings out the global inflationary pressures following the recent rise in food prices. Ashima Goyal and Shruti Tripathi derive a test to quantify the impact of food prices. Since consumer prices are a weighted average of the prices of domestic and of imported consumption goods, domestic prices feed into final consumer prices. Therefore domestic price inflation (WPI) should cause Consumer Price Inflation (CPI), with a long-term equilibrium relationship between consumer and domestic price inflation and the exchange rate. But in the context of a low-income country such as India, average

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wages respond to the food component of CPI. Cost of production and hence domestic prices tend to rise, in which case CPI inflation, for which food is the dominant component Granger causes WPI inflation. This reverse causality is derived from a new Keynesian Aggregate Supply (AS) framework with a wage-price link added. Time series tests, with controls for other variables affecting the indices, provide evidence of reverse causality. Both the identity and the AS hold as long-run cointegrating relationships. Differential supply shocks have a major role in explaining the divergence in the indices, whereas insignificance of the demand variable in short-run adjustment indicates elastic AS. Exchange rate depreciation affects inflation, while food price inflation impacts inflation dynamics, supporting a key result in the literature that supply side factors dominate monetary factors in generating inflationary pressure in many emerging market economies.

In his paper, Keshab Bhattarai evaluates the impact of exchange rate and money supply on growth rates, inflation and interest rates for the UK economy. Results of a simultaneous equation model show that the depreciation of pound sterling, by enhancing the international competitiveness, has contributed to the growth of output and money supply, thus making the role of money non-neutral in the short-run. Inflation – driven by money growth, the depreciation of pound and higher interest rates – has adversely contributed to output growth. Interest rates are not only persistent but higher interest rates coexist with greater degree of liquidity in the financial system and this is possible only because of the predominance of London as the financial centre in the global economy. The reduced form parameters of a three equation simultaneous equation model – shown to be highly non-linear in the structural coefficients analytically – are estimated using ILS, 2SLS and 3SLS techniques. The paper finds simultaneity among GDP growth, inflation and interest rates in terms of exogenous factors namely growth rate of money supply, exchange rate, and lagged interest rates. New empirical evidence discussed here complements the previous findings in the literature.

In the third paper, Rajeev Sooreea and Mark Wheeler empirically examine the response of stock prices in Germany, Italy, and the UK to shocks in US stock prices. The analysis is done by estimating vector error correction models (VECMs) and cross-country correlations of stock returns. Their results imply that positive shocks to stock prices in the USA lead to significant and positive responses in stock prices in Germany, Italy, and the UK, with the strongest responses observed in the UK. The Variance Decompositions (VDCs) indicate that shocks to US stock prices explain over 43% of the forecast error variance in European stock prices. In contrast, shocks to domestic variables never lead to significant responses in European stock prices. Hence, stock prices in these countries respond to shocks to US stock prices rather than to domestic forces. Moreover, there is evidence of strong cross-country stock return correlations between the US stock market and these European stock markets in all states of the world. Taken together, these results suggest that cross-country co-movements in stock prices occur irrespective of the evolution of market fundamentals. This indicates strong interdependence between the US stock market and stock markets in the UK, Germany and Italy.

The fourth paper by Flora Cunha Lobo, Pedro Ramos and Óscar Lourenço explores how fiscal decentralisation can create adverse incentives for excessive local borrowing, thereby imposing significant challenges for macroeconomic management. In the case of severe financial distress, the provision of local public goods and services may be severely impaired. This paper analyses the factors behind the financial distress of local

government in Portugal, focusing on three main causes: local financial management, political factors and the socio-economic development of municipalities. A Probit model is used to estimate the probability of a municipality entering into a financial recovery contract, regulated by the Portuguese Local Finance Law. Empirical results indicate that both structural and non-structural factors influence local financial distress. In addition to financial management practices, financial distress is also conditioned by political variables and socio-economic factors. Municipalities ruled by mayors that belong to a right-wing party are more prone to financial distress, and some municipalities are more financially vulnerable than others because of structural circumstances.

The next paper by Saurabh Agarwal provides a quantitative treatment to formalise the effect of demographic variables like marital status, gender, occupation and age on the source of investment advice, which in turn affects the herd behaviour of investors and probability of investment success in near future. Further, postulations have been made for most preferred investment option and purpose of saving and source of investment. Impact of theoretical analysis on choice among investment alternatives has also been investigated. The analysis contributes to understanding the different investment choices made by households in India. The insights offered in the paper indirectly contribute to uncovering the various unexplained asset pricing puzzles.

Finally, P.L. Beena and Hrushikesh Mallick examine the extent to which the exchange rate matters in determining the export performance in the Textiles and Clothing (T&C) sector. From the panel regression analysis of eight major exporting partner countries of Indian T&C sector, the study found an inverse relationship between the rises in exchange rate and exports. This suggests that the devaluation of Indian rupee has not helped boost the exports of T&C sector. The findings further indicate the significant role of demand factor in determining export growth. The authors argue that exchange rate intervention alone may not be the right solution for export promotion and therefore government should not place much emphasis on devaluing the exchange rate as a policy option to promote export competitiveness.

Overall, the papers in this special issue focus on questions related to inflation, exchange rate and financial shocks, in an attempt to contribute to the broader debate on transmission of different macroeconomic and financial shocks. The diversity of topics analysed in this issue provide us with a rather good insight into the problems facing many governments following the recent financial crisis. The papers are indeed topical reflecting the current challenges facing the global economy. The application of a range of relevant econometric methodologies provides robust evidence, from which appropriate policy implications have been drawn.

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