



## Introduction to the special issue on International Finance

Globalization and the process of integration of international financial market have contributed to an increased importance of international finance. Individual as well as institutional investors allocate their portfolios across scores of countries and firms raise capital in global markets to a larger extent than ever before. Both these developments require integrated capital markets. Firms are also learning how to adapt to a world with increasingly volatile foreign exchange rates, be it through financial or operational hedging or both. Policy makers face the challenge of creating open and transparent financial markets, while dealing with cross-border regulatory arbitrage by firms and investors. As investors, firms, and policy makers struggle to learn how to deal with globalization, they are increasingly looking to guidance from academic research.

To further stimulate research and empirical analysis in the field of international finance, a conference was organized by the Journal of Empirical Finance from June 30 until July 2, 2005 at Maastricht University. The refereed proceedings of the conference are contained in this special issue. The editors feel that they provide an important contribution to the theory, institutional knowledge and empirical analysis in the field of international finance. The research findings reported herein provide new insights into a selection of very important topics in international finance: International portfolio diversification, integration of emerging markets, and foreign exchange risk and asset prices. Our hope is that the findings contained in this volume will also be useful for policy makers as they work to facilitate the globalization process.

Three papers deal with international portfolio diversification.

The first paper in the area of International Portfolio Diversification, *Geographic versus Industry Diversification: Constraints Matter*, by Paul Ehling and Sofia Ramos addresses the issue whether geographic diversification is more beneficial than industry diversification in the Euro-zone. Data for eleven Euro-zone countries and ten sectors for the period 1990–2005 are used. In the absence of constraints, no empirical evidence is found to support the argument that geographic diversification dominates industry diversification, with the exception of the Euro period. With short-selling constraints, geographic diversification cannot be achieved through industry diversification.

In the second paper, *Sources of Gains from International Portfolio Diversification*, José M. Campa and Nuno Fernandes investigate the determinants of country and industry specific factors in international portfolio returns using a sample of forty-eight countries and thirty-nine industries over the period 1975–2005. The importance of industry and country factors is found to be correlated with the measures of economic and financial international integration and development. Country factors are smaller for countries integrated in world financial markets

and have declined as the degree of financial integration increased. Higher international financial integration within an industry increases the importance of industry factors in explaining portfolio returns.

In the third paper, *Local Risk Factors in Emerging Markets: Are They Separately Priced?*, Francesca Carrieri, Vihang Errunza and Basma Majerbi provide new evidence on the pricing factors in seven major emerging stock markets in Asia and Latin America for the period 1976–2000. They investigate whether there is a significant local currency premium and a domestic market risk premium in equity returns using a partial integration asset pricing model. A significant exchange risk premium is found, exchange rate and domestic market risks are separately priced, local currency risk is found to be on average smaller than domestic market risk, but it increases during crises when it can be almost as large as market risk.

The fourth paper, *Non-synchronous Trading and Testing for Market Integration in Central European Emerging Markets*, by Peter C. Schotman and Anna Zalewska contributes to the literature on integration of emerging markets by addressing the issue of non-synchronous trading. They argue that controlling for time differences in trading hours of stock markets is important and show that time-adjustment improves estimates of market integration. Using weekly frequency instead of daily returns does not sidestep the consequences of the time-match problem but leads to significant loss of information. The process of integration of stock exchanges operating in the Czech Republic, Hungary, and Poland with the stock markets of Germany, UK and US in the period 1994–2004 has been very dynamic.

The next three papers deal with the issue of foreign exchange risks and asset prices.

The fifth paper, *Asymmetric Foreign Exchange Risk Exposure: Evidence from US Multinational Firms*, by Aline Müller and Willem F. Verschoor examines how US multinational firms are affected by foreign currency movements. They find that 29% of a sample of 935 US firms with real operations in foreign countries was significantly affected by currency movements between 1990 and 2001. US stock returns were found to react asymmetrically to currency movements. By introducing nonlinearity in foreign currency risk exposure, the precision and the significance of exposure estimates are increased. Moreover, asymmetries are more pronounced towards large versus small currency fluctuations than over depreciation and appreciation cycles.

In the sixth paper, *The Impact of the Introduction of the Euro on Foreign Exchange Rate Risk Exposures*, using weekly returns for the period 1990–2001 for 3220 non-financial firms from 18 European countries, the United States and Japan, Söhnke M. Bartram and G. Andrew Karolyi find that though the Euro's launch in 1999 was associated with an increase in total stock return volatility, significant reductions in market risk exposures arose for non-financial firms both in and outside of Europe. Reductions of market risk were concentrated in firms domiciled in the Euro area and in non-Euro firms with a high fraction of foreign sales or assets in Europe. The introduction of the Euro led to a net absolute though statistically and economically small decrease in foreign exchange rate exposure of non-financial firms.

The seventh paper, *Measuring the Economic Importance of Exchange Rate Exposure*, by Graig Doidge, John Griffin and Rohan Williamson re-examines the nature and the economic significance of the exchange rate to firm value relation using data of non-financial firms from over 18 countries for the period 1975–1999. Applying a portfolio approach to investigate the economic importance of exposure, they find that firms with high international sales outperform those with no international sales during periods of large currency depreciations by 0.72% per month, whereas these firms underperform by 1.10% per month during periods of large currency

appreciations. In contrast to the previous literature, their evidence shows that exchange rate movements can have an economically significant impact on firm value.

Finally, the editors of the special issue have the pleasure to announce that Söhnke M. Bartram and G. Andrew Karolyi are the recipients of the biennial Best Paper Award for their paper entitled “*The Impact of the Euro on Foreign Exchange Rate Risk Exposures*” which has been highest rated.

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