International Financial Markets
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Have become extremely integrated over time because of Globalization.

Can be segmented as follows:

1. The Foreign Exchange Market
2. The International Money Market
3. International Capital Market:
   (a) bond market, and
   (b) stock market
1. The Foreign Exchange Market

FX Market Structure

- A 24-hour market where currencies are traded to facilitate BOP adjustments
- A $5 trillion/day market: most widely traded currencies include $, €, ¥, and £
- Major FX centers: London, New York, Tokyo, Hong Kong, Singapore, and Dubai
- Other FX centers are located in the major commercial cities of countries
Key Players in FX Markets

• Currency traders and FX brokers
• Major commercial banks
• Speculators
• Central Banks of countries

Each of the above players has its own objective for participating in the FX market.
• The foreign exchange market allows currencies to be exchanged in order to facilitate international trade or financial transactions (recall BOP statistics).

• The system for exchanging foreign currencies has evolved from the gold standard, to agreements on fixed exchange rates, to a floating rate system.
The Spot Market for Foreign Exchange

- The market for immediate delivery and exchange of currencies is known as the spot market.
- Currency trading between banks occurs in the interbank market. Within this market, brokers sometimes act as intermediaries.
- The exchange rate quoted in newspapers are for large transactions of over $1 million.
The Forward Market for Foreign Exchange

- The **forward market** enables traders and firms/banks to **lock in the exchange rate** today to buy or sell a certain quantity of currency on a specified future date, e.g., 30, 60, 90 or 180 days from today.

- Customers in need of foreign exchange are concerned with quote competitiveness, special banking relationship, speed of execution, current market conditions, and forecasting advice.
Foreign Exchange Transactions

- Banks provide foreign exchange services for a fee: a bank’s bid (buy) quote for a foreign currency will always be less than its ask (sell) quote.

\[
\text{bid/ask spread} = \frac{\text{ask rate} - \text{bid rate}}{\text{ask rate}}
\]

Example
Suppose bid price for £ = $1.52, ask price = $1.60.

\[
\text{Spread} = \frac{(1.60 - 1.52)}{1.60} = .05 \text{ or } 5\%
\]
The “bid-ask” Spread

- The **spread** (profit margin) on currency quotations is positively influenced by order costs, inventory costs, and currency risk, and negatively influenced by competition, and volume.

- The spread for heavily traded currencies like the $, €, £, and ¥ are low because of their **liquidity**.
Foreign Exchange Quotations

- The exchange rate quotations published in newspapers normally reflect the ask prices for large transactions.

- **Direct quotations** represent the value of a foreign currency in dollars ($/€), while **indirect quotations** represent the number of units of a foreign currency per dollar (€/$).

- Indirect quotation = \( \frac{1}{\text{Direct quotation}} \)
A cross exchange rate reflects the amount of one foreign currency per unit of another foreign currency.

**Example**

Direct quote: $1.50/£, $.009/¥

Indirect quote: .67£/$, 111.11¥/$

Value of £ in ¥ = \[
\frac{\text{value of £ in $}}{\text{value of ¥ in $}}
\]

= \frac{1.50}{.009}

= 166.67¥/£
Motives for Using the International Money & Capital Markets

• The market for real or financial assets are prevented from full integration by barriers like tax differentials, tariffs, quotas, labor immobility, communication costs, cultural and financial reporting differences.

• Yet, such market imperfections also create unique opportunities for specific geographic markets, helping these markets attract foreign creditors and investors.
Motives for Using the International Money & Capital Markets

- Investors move funds to foreign markets:
  - to take advantage of favorable economic (e.g. interest rates) conditions;
  - when they expect foreign currencies to appreciate against their own; and
  - to reap the benefits of international diversification.
Motives for Using the International Money & Capital Markets

• Creditors provide loans in foreign markets:
  • to capitalize on higher foreign interest rates;
  • when they expect foreign currencies to appreciate against their own; and
  • to reap the benefits of diversification.

• Borrowers seek funds in foreign markets:
  • to capitalize on lower foreign interest rates;
  • and when they expect foreign currencies to depreciate against their own.
2. The International Money Market

- It is a short-term market (< 1-year maturity)
- Financial institutions in this market serve firms and investors by accepting deposits and offering loans in a variety of currencies.
- Multinational banks try to meet the short-term (less than a year) needs of their customers, i.e., accepting MNC deposits and making loans (e.g., working capital) in various currencies.
The Eurocurrency Market

• History, characteristics, and growth (money multiplier) of the Eurodollar market: the Cold War and freezing of dollar deposits

• Investing dollars with non-US financial institutions in Europe (London), i.e., outside the control of the US Government, the Fed, FDIC, etc.

• The Eurocurrency market (75% Eurodollars) developed during the 1970s, stimulated by regulatory changes in the U.S. and the growing savings surplus of OPEC.
International Banking

• The move to standardization of global banking regulations by the BIS has contributed towards the globalization of the industry.
  • The Single European Act opened up the European banking industry and increased its efficiency.
  • The Basel Accord outlined risk-weighted capital adequacy requirements for banks.
  • The Basel II & III Accord attempts to account for operational risk and bank capital adequacy.
3. International Capital Markets

- It is the market for raising long-term capital
- MNCs sometimes obtain medium or long-term capital from global banks for foreign direct investment, M&A activity, and international portfolio investments
- **Eurocurrency loans** refer to loans of one year or longer extended by banks initially in Europe to foreign MNCs or government agencies.
- Such loans are generally based on the **LIBOR**.
Syndicated Loans

- Sometimes a single bank is unwilling or unable to lend the total amount needed by a particular MNC or government agency.
- A lead bank may then organize a *syndicate* of banks to underwrite that loan.
- Borrowers that receive a syndicated loan typically incur front-end management and commitment fees, in addition to the floating rate interest on the loan.
International Bond Market

There are two types of international bonds:

1. Bonds denominated in the currency of the country where they are placed but issued by borrowers foreign to that country. They are called **foreign bonds** or **parallel bonds**.

2. Bonds that are sold in countries other than the country of the currency (denominating the bonds) are called **Eurobonds**. Usually, they are issued in bearer form, pay annual coupons, and have call provisions. Some also carry convertibility clauses, or have variable rate provisions.
International Bond Market

- 70 to 75 percent of Eurobonds are denominated in the U.S. dollar.
- Eurobonds are underwritten by a multi-national syndicate of investment banks and simultaneously placed in many countries.
- In the secondary market, the market makers are often the same underwriters who sell the primary issues.
Comparing Interest Rates Among Currencies

- Interest rates are crucial because they affect the MNC’s cost of financing.
- The interest rate for a specific currency is determined by the demand for and supply (Monetary Policy) of funds in that currency.
- As the demand and supply schedules for a specific currency change over time, the equilibrium interest rate will also change.
International Stock Markets

• In addition to issuing stock locally, MNCs can also obtain investor funds by issuing stock in international markets.

• This will enhance the firms’ image, name recognition, diversify their shareholder base, and match currency revenues with expenditure.

• A stock offering may also be more easily digested when it is issued in several markets.
International Stock Markets

- Non-U.S. firms may also issue American depository receipts (ADRs), which are certificates representing bundles of stock.

\[ P_{\text{ADR}} = P_{FS} \times S \]  

(spot rate in $/LC)

- The locations of an MNC’s operations can influence the decision about where to place its stock, in view of the cash flows needed to cover dividend payments.

- Stock market characteristics are important. Stock markets may differ in size, trading activity level, and proportion of individual versus institutional share ownership.
MNC Use of International Money and Capital Markets

- The foreign cash flow movements of a typical MNC can be classified into:
  1. Foreign trade flows – exports and imports
  2. Direct foreign investment (DFI) activity – acquisition of foreign real assets
  3. Short-term investment or working capital needs
  4. Longer-term financing in the international bond or stock markets
How Financial Markets Affect an MNC’s Value

- Since interest rates commonly vary among countries, an MNC may use the international financial markets to reduce its cost of capital, thereby achieving a higher valuation.