International Financial Markets

Can be broadly be segmented into three categories:
(1) The Foreign Exchange Market
(2) International Money Market
(3) International Capital Market: (a) bond market, and (b) stock market

(1) The Foreign Exchange Market: Is a 24-hour market where currencies are traded to facilitate balance of payments adjustments, i.e., facilitating current account as well as capital/financial account transactions. It is a $1.9 trillion/day market with major centers located in London, New York, Tokyo, Hong Kong, Singapore, Dubai and Bahrain. Most major countries have foreign exchange markets located in their own financial centers.

The key players in the FX market are currency traders, commercial banks, foreign exchange brokers, speculators, and central banks of countries that operate through commercial banks in their respective countries. Each of these FX market players has his/her own objective for participation in the FX market.

Foreign currencies can be bought for immediate delivery (spot market) at the “spot” rate or for future (30, 60, or 90 days) delivery at the “forward” rate. The quoted exchange rate at which a bank “buys” a currency from a customer is called the “bid” rate and the exchange rate at which a bank “sells” a currency to a customer is called the “ask” rate. The “bid” rate at a bank will always be lower than the “ask” rate at the same bank for the currency under consideration (buy low and sell high). The difference between the bid and ask rate is called the “spread,” and it is the profit made by the bank/broker.

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

The spread (in percentage) on a currency quotation is positively influenced by order (transactions) cost, inventory (illiquidity) cost, and currency risk (volatility). Spread is negatively influenced by competition, liquidity, and volume. Most widely traded currencies: $, euro, pound, yen.

The exchange rate quoted in newspapers is for large transactions of $1 million or more. Direct quotations: $/LC
Indirect quotations: LC/$ = 1/Direct quote

(2) International Money Market: Financial institutions, primarily 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.

History, characteristics, and growth of the Eurocurrency market:
History vis-à-vis dollar balance of payments surplus in the Soviet Union (early 1960s)
• Risk (freezing of financial assets due to political disagreements) of investing dollar assets with US banks
• Creation of Eurodollars by investing dollars with non-US financial institutions in Europe (London), i.e., outside the control of the US Government, the Fed, FDIC.
• Short term (as little as a couple of days) time deposits in large amounts (millions)
• Low operating cost because it is an unregulated (no required reserves, interest rate controls, FDIC insurance, etc.) market
• Rapid growth of Eurocurrencies (approx. 75% Eurodollars), largely an inter-bank market with LIBOR floating interest rates based on underlying rate
• Euro credit market offer medium-term loans in eurocurrencies
• Milton Friedman and Fred Klopstock argument over the rapid growth of Eurodollar market
• Money Multiplier = \[ \frac{1}{\text{Required reserves} + \text{leakage}} \]


(a) Long-term loans: A lead banks could arrange syndicated loans that could include front-end management and commitment fees, in addition to floating interest rates on borrowing. Loans to developing countries may include an IFC (International Finance Corporation) loan component.

(b) Long-term bonds: Foreign bonds (or parallel bonds) are denominated in the currency of the country where they are placed, but issued by borrowers/MNCs of another country. Euro bonds are denominated in a currency other than of the country where they are placed. About 75% of Eurobonds are Eurodollar bonds. The interest rate on bonds reflects the underlying interest rate of the currency.

(c) International Stock Markets: Have grown rapidly over the recent past because of (i) privatization and capital market development in emerging market economies, (ii) strategic decisions by MNCs to issue equity (and raise capital) in overseas markets as a means of shareholder (investor) diversification and foreign savings mobilization, and (iii) the need to minimize foreign exchange exposure (through location of operations), and to gain name recognition abroad as well. Yankee and Samurai stock offerings are good examples. ADRs and GDRs are investment certificates representing single or a bundle of foreign stocks sold through investment banks in foreign markets.

\[ \text{ADR}^{\text{S}} = \text{P}_{\text{R}} \times S \quad (\text{spot rate in S/LC}) \]

Foreign stock market characteristics (listing, liquidity, individual vs. institutional ownership) are important (see Emerging Market Indicators) for growth.

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